the Budget 1992

Budget Papers

tabled in the House of Commons by
the Honourable Don Mazankowski
Minister of Finance

Canada

February 25, 1992

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Department of Finance Canada   Ministère des Finances Canada

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CHAPTER 1: THE POLICY FRAMEWORK

INTRODUCTION

Canada has done best economically when it has pursued sound medium-term economic policies. It has done least well when it has lost sight of those medium-term goals and lapsed into short-term palliatives.

Canadians have achieved one of the highest standards of living and qualities of life found anywhere. For most of the postwar period, Canada's economic performance was stellar. Strong growth underpinned by strong productivity growth and a stable macroeconomic environment meant rising wealth and prosperity. Canadians used this wealth to create a unique society, one in which citizens enjoy unparalleled access to economic opportunities, combined with universal access to health care, education, and multiple forms of income security.

In the 1970s and early 1980s, however, Canada and the other industrialized economies were buffeted by several economic upsets, including two oil price shocks and a worldwide productivity slowdown. Policy responded by becoming preoccupied with short-term goals. The economy started experiencing boom-bust cycles in growth and inflation. Stagflation – the apparent co-existence of high inflation and high unemployment – became a major worry. Improvements in real incomes slowed and Canada's economic performance became unsatisfactory. Canadians began to fear that we were destroying the foundation on which we had built our prosperity and our society: a strong economy. Canadians began to ask how Canada could do better.

Much of the answer could be found in the experience of other countries and in our own economic record. Internationally, different countries tried different policies. Those that encouraged adjustment and adaptation while maintaining a stable macroeconomic policy environment – in effect, the Canadian policies until the early 1970s – were successful. Those that tried to evade the new economic realities created problems that later exacted a heavy price.

The lessons of the international and Canadian experience are straightforward. A stable, strongly growing economy, one which can afford its key social programs, requires a return to many of the policies of the pre-1970s period, but with modifications to reflect the opportunities and limits imposed by today's global economy. Today this means:

- persistence in reducing fiscal deficits and debts;
- persistence in keeping inflation low and stable;
- encouragement of yet more open trading relationships;
- reliance on the private sector and market forces to raise productivity and generate new wealth; and
- recognition that government involvement in the economy must be conditional on the willingness of Canadian citizens to pay for public services and the need to keep the economy competitive.

This chapter reviews these key postwar policy lessons, both internationally and in Canada. It describes how these lessons underlie the important Canadian policy changes of the mid-1980s. The chapter concludes by describing the progress of the economy toward the new goals and the further progress now needed.

THE INTERNATIONAL EXPERIENCE

In the face of the unprecedented economic challenges of the 1970s, some countries responded with policies to encourage adjustment and adapt to change while controlling their fiscal balances and resisting inflation pressures. Many of these countries paid a short-term cost but emerged in the 1980s as dynamic economies, with strong growth in productivity and real incomes. Germany and Japan are two examples which have, in the 1980s, successfully managed to keep inflation and unemployment low, while eliminating fiscal and current account deficits.

Many other countries postponed adjustment, increased government's economic intervention to try to deal with problems, let fiscal deficits and debt rise substantially, and let inflation rise and become entrenched. In virtually every case, the postponement of adjustment worsened economic performance.

By the early 1980s, many of these countries changed course, reducing government intervention, eliminating fiscal deficits, acting to lower inflation, and reducing international barriers to trade. As well, the European economies started moving strongly to reduce internal barriers to trade and mobility.

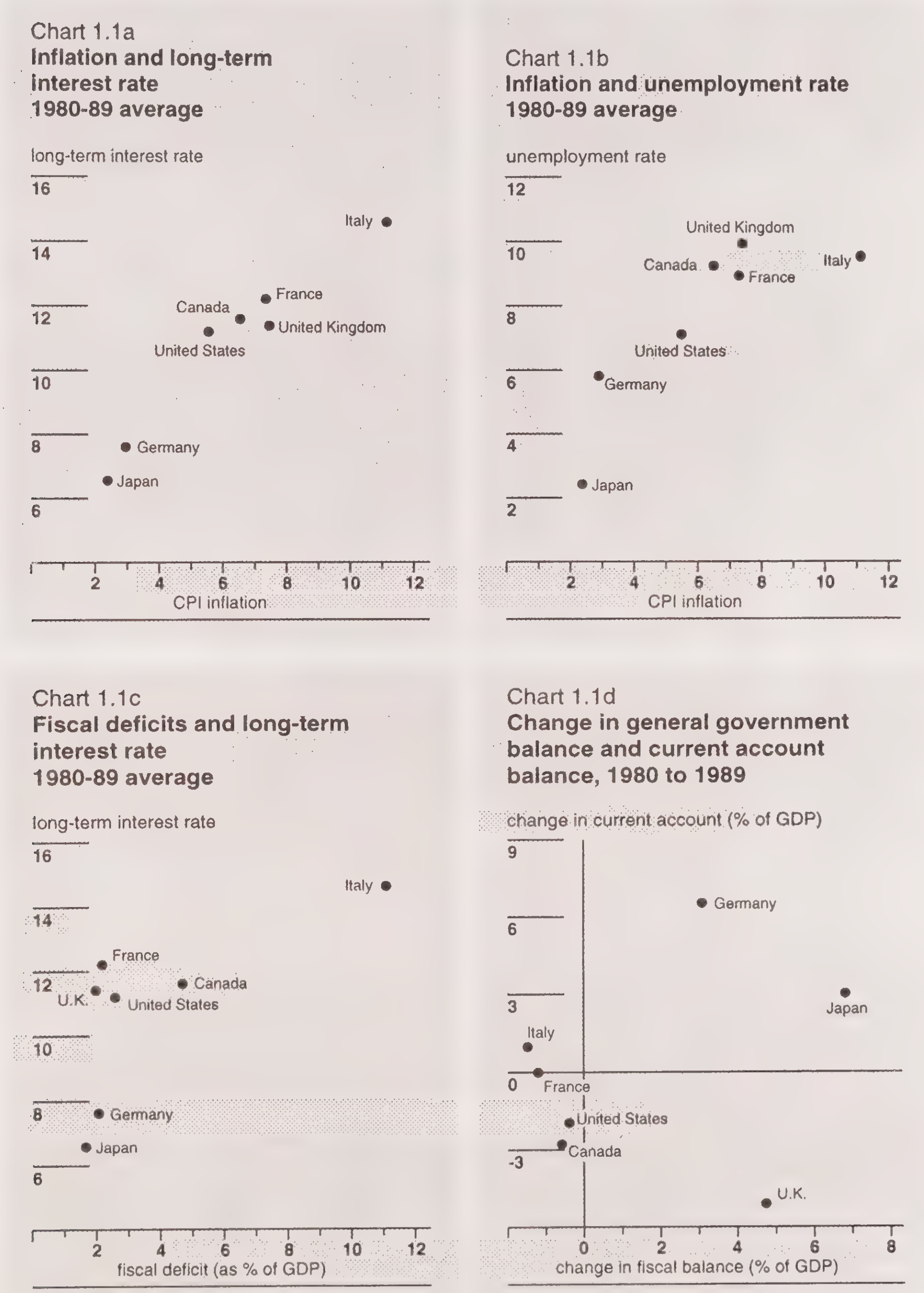
France, for example, altered course after a surge in inflation, which rose to 13.6 per cent by 1980, a sharp rise in the fiscal deficit, a loss of confidence in economic policy, a speculative run on the franc, and a sharp deterioration in its trade balance. Now, with new policies, France is expected to have the lowest fiscal deficit amongst the large European economies and has inflation and interest rates near those of Germany. This has laid the foundation for a much more competitive French economy as Europe moves towards full economic and monetary integration.

The United Kingdom, on the other hand, is an example of an economy that lowered inflation and raised productivity in the early 1980s. As the economy boomed in the late 1980s, however, the money supply was allowed to expand too rapidly. Inflation rose sharply from 3.4 per cent in 1986 to 9.5 per cent in 1990, and interest rates followed. The authorities had to tighten monetary policy and the U.K. went into a deep recession. Employment fell 3.6 per cent in 1991 and the unemployment rate rose by 2.2 percentage points to 8.0 per cent on average and higher by year-end. Yet they have still not regained full control over their inflation problem: consumer prices rose 5.9 per cent last year.

The U.K. example shows the need to be constantly on guard against inflation pressures. Germany and Japan have low inflation because they react quickly when their good inflation record is threatened. For instance, in the past three years, German reunification has contributed to strong demand in the German economy and increased inflation pressures. German interest rates have risen sharply, with the Lombard rate rising from 5.5 per cent at the end of 1988 to 9.75 per cent now and the discount rate more than doubling. By the end of 1992, German inflation pressures will subside and German interest rates will decline again.

The first of many important lessons from these experiences is that high inflation leads to high interest rates (Chart 1.1a). The second is that inflation does not help growth and cannot permanently lower unemployment. In fact, the reverse appears to be true (Chart 1.1b). The third lesson is that high fiscal deficits do not stimulate growth in any permanent way. They put upward pressure on inflation and interest rates (Chart 1.1c) and can drain an economy's domestic savings, either reducing investment or increasing foreign

Chart 1.1
Performance of the G-7 economies in the 1980s



Source: OECD Economic Outlook.

borrowing (Chart 1.1d). The fourth lesson is that the private sector and open trade are the best engines for growth in productivity and living standards.

The 1970s and 1980s made clear that the economies with the lowest inflation and the lowest fiscal deficits had the best economic performance. They displayed healthy growth in productivity and employment. The experience across the world shows that economies that moved toward more open trading relationships – the countries of North America, Western Europe and the Pacific Rim – prospered while those that had turned away from trade – Mexico and India – stagnated. Many of those that turned away from trade are now seeking to expand trade; Mexico is an example.

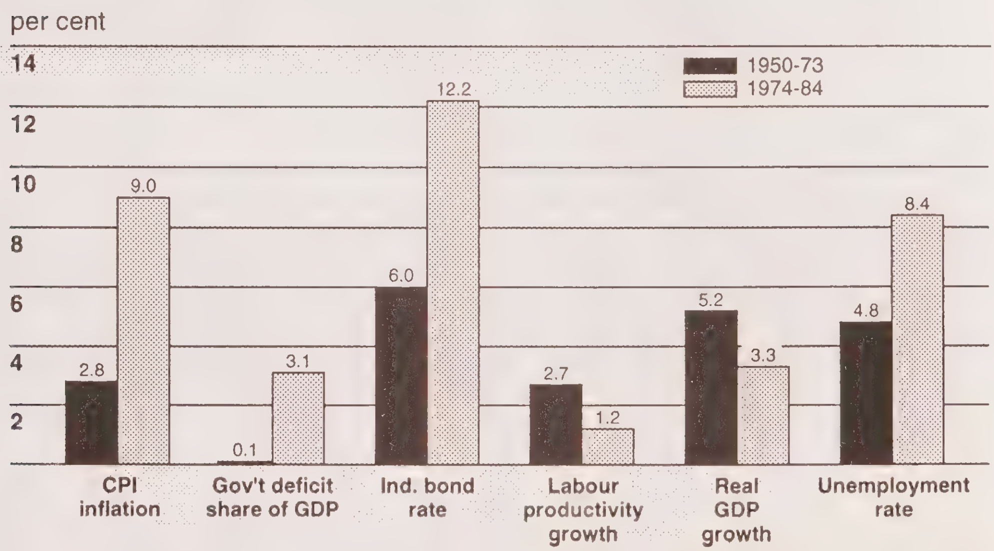
THE CANADIAN EXPERIENCE TO 1984

Sticking to the basics up to the early 1970s

A favourable policy environment

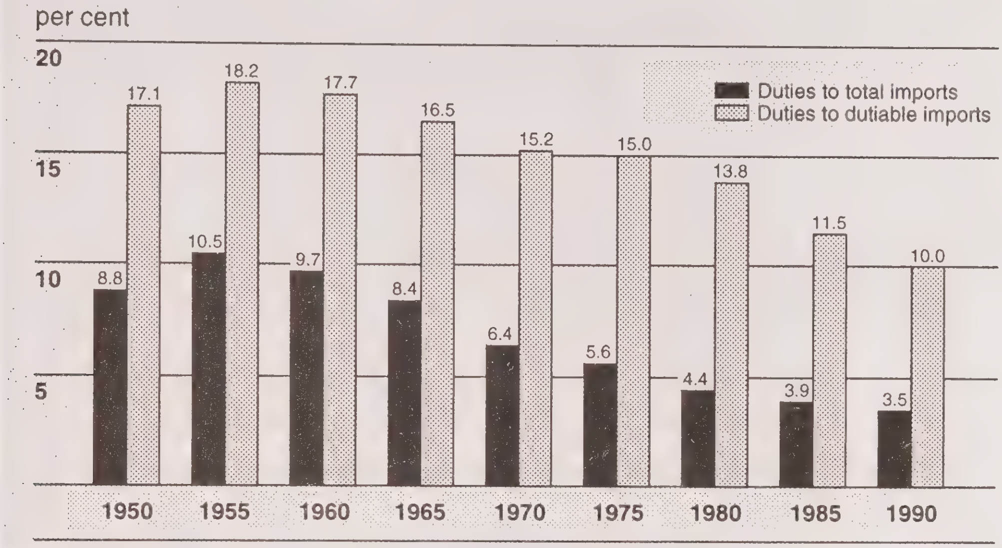
Until the early 1970s, Canadian governments consistently followed certain key policies which created an environment favouring growth (Chart 1.2). They first limited the role of government in the economy. Government provided basic public services, established an affordable and effective system of health care and a safety net to help Canadians most in need. They invested in essential resources such as education, transportation, and communication systems, often in co-operation with the private sector. These policies were affordable and contributed directly to a wealthier Canada. Federal government program spending from 1950 to 1973 was held steady at an average 14.6 per cent of gross domestic product (GDP); provincial-local-hospital (PLH) spending increased only moderately. Canada's overall public spending as a share of GDP was similar to the average in the Group of Seven (G-7) industrialized economies.

Chart 1.2
Performance of the Canadian economy 1950-73 and 1974-84



Sources: Statistics Canada and Bank of Canada.

Chart 1.3
Canadian duty collected as a percentage of imports 1950 to 1990



Source: Statistics Canada.

The second key policy of the period was for government to pay its way. In this way structural problems were avoided. From the early 1950s through the early 1970s, all governments kept Canada's finances in good shape. They generally held program spending below revenues so that their operating balances – that is, the balance before interest payments – were usually in surplus. The operating surplus combined with the effects of low inflation on interest costs meant Canadian governments collectively had virtually no deficit, as a share of GDP, on average between 1950 and 1973. At the federal level, the national debt, as a per cent of GDP, was cut by nearly two-thirds between the beginning of the 1950s and fiscal year 1974-75.

The third key policy of Canada's years of strong economic growth was to keep inflation low and in line with its major trading partners. Low inflation reduced uncertainty, keeping the real cost of capital and interest rates low; this encouraged strong investment and helped keep government finances healthy. It provided a stable environment in which businesses and individuals could undertake long-term planning, fostering a long period of strong growth in output, productivity, and real incomes.

The fourth key policy was to progressively open Canada to more trading opportunities. The Canada-United States Auto Pact and the tariff reductions of the Kennedy Round of the General Agreement on Tariffs and Trade (GATT) continued Canada's policy of lowering tariffs and other trade barriers (Chart 1.3). More open trade has resulted in broader choices for consumers and strong productivity gains from specialization and rationalization. More open trade also helped many of the world's economies recover from the ravages of the Second World War and start catching up to North American productivity and living standards.

The payoff – A healthy economy . . .

The Canadian economy prospered from the early 1950s to the early 1970s. Real GDP growth averaged 5.2 per cent a year. Output per worker increased at 2.7 per cent a year and supported strong growth in real wages. The average worker could expect real income to double roughly every generation. The unemployment rate averaged 4.8 per cent, showing that low inflation was consistent with low unemployment. From 1950 to 1973, the Scotia-McLeod industrial bond rate averaged 6.0 per cent while the real interest rate was roughly half that. Keeping inflation low kept interest rates low.

The achievement was the more impressive because it occurred in a period of massive structural change resulting from new trading opportunities, new investments in transportation infrastructure, such as the Seaway and the TransCanada highway system, strong growth in the labour force, and strong productivity gains. One of the most dramatic changes was the reduction in farm employment from 18.5 per cent of total employment in 1951 to only 6.4 per cent in 1971 as a result of exceptionally strong growth in farm productivity. Yet, while firms and workers had to adjust to rapid technical, social, organizational, and economic change, strong growth provided the new opportunities they needed.

. . . with an improved social safety net

Strong growth and fiscal balance led to steady declines in federal debt as a proportion of GDP, the ratio falling to a low of 17.8 per cent by 1974-75. This was less than a third the debt of 56.2 per cent of GDP in 1950-51. Much of the debt was accounted for by the government's investments in fixed capital. Public debt charges consumed less than 12 cents on the dollar of federal revenues.

Governments had the fiscal flexibility to meet emerging needs and challenges. They introduced new, national, social programs, such as the Canada and Quebec Pension Plans (CPP/QPP), Medicare, and a more comprehensive system of unemployment insurance, as the economy could support them. The existence of this basic, national, social safety net helped encourage geographic mobility and adjustment to the challenges of the period. These programs became an essential element of what defines Canadian society and citizenship.

. . . and the ability to respond

The openness of the Canadian economy and the importance of the resource sector has meant that the Canadian economy has always been sensitive to external shocks. During the 1950s and 1960s, the economy did experience a number of cyclical slowdowns and downturns. On average, downturns lasted three quarters with the level of GDP falling 1.3 per cent. The unemployment rate would rise by 2.7 percentage points. Because fiscal positions were healthy, and inflation was kept low, governments were in a better position to respond to these cyclical downturns. On average, the total government balance would worsen by 2.6 per cent of GDP, due to automatic stabilizers and, in certain cases, discretionary actions.

In the recovery phase, usually all of the output loss was made up within two quarters. As the recoveries took hold, governments moved to balance their fiscal position. In this way, deficits were never allowed to become structural, giving government the capacity to respond quickly and effectively to future cyclical problems.

Losing sight of the basics in the late 1970s and early 1980s

Changing policies

In the 1970s, productivity growth slowed in Canada and the other major industrial countries of the world. As well, Canada and the rest of the industrialized world were buffeted by two oil price shocks. Increasing global trade and interdependence posed new and difficult challenges as new competitors emerged. These competitors included the European economies and Japan, which had recovered from the Second World War, and the emerging, dynamic economies in the rest of Asia. Some countries coped better than others with the new environment. In Canada, governments responded to worsening economic performance by trying to protect Canadians from these challenges rather than helping Canadians confront and surmount them. Many policies of those years treated the problems as temporary or sought to postpone them until later. In many cases, policies created new problems of their own; many are still with us. A preoccupation with short-term goals at the expense of medium-term performance was common to all these policies. Whatever gains they created were fleeting.

More government intervention

It became policy to increase the influence of government in the economy through the heavy hand of regulation and intervention. This included such programs as the *Foreign Investment Review Act* (FIRA), the National Energy Program (NEP) of 1980, expanded regulation of transportation and communications, and the establishment of a host of new Crown corporations. This was so both federally and provincially.

The tax system also was changed as a plethora of special tax credits and incentives were introduced to encourage Canadian businesses and workers to follow short-term priorities. Tax expenditures – use of special tax breaks as a substitute for direct government spending – became extensive, amounting to billions of dollars. The results were narrow tax bases and high statutory rates. The changes distorted investment decisions, which became increasingly based on tax advantages or disadvantages rather than economic fundamentals. As a result, Canada's capital was not put to its most productive use.

Failing to adapt

It also became policy to try to insulate Canadians from international developments and competition. The government tried, for example, to shield Canadian industries, such as textiles and clothing, and shipbuilding, from new competition through everything from tariffs and quotas to negotiation of voluntary export restraints. The consequences were much higher costs for consumers and, in many cases, a failure of the industries to adapt to new realities. Such policies sapped entrepreneurial initiative. They were better at supporting the industries that failed to upgrade and adapt than encouraging those that did upgrade and adapt. In the end, the policies only contributed to stagnating productivity growth.

Letting inflation get out of control

In the 1970s, slowing productivity slowed growth. At the same time, the unemployment rate was drifting up as a result of demographic changes and expansion of the unemployment insurance system. Governments interpreted this as an economy operating below its potential. At the time, governments also believed that there was a trade-off between inflation and unemployment: that somewhat higher inflation could permanently lower unemployment.

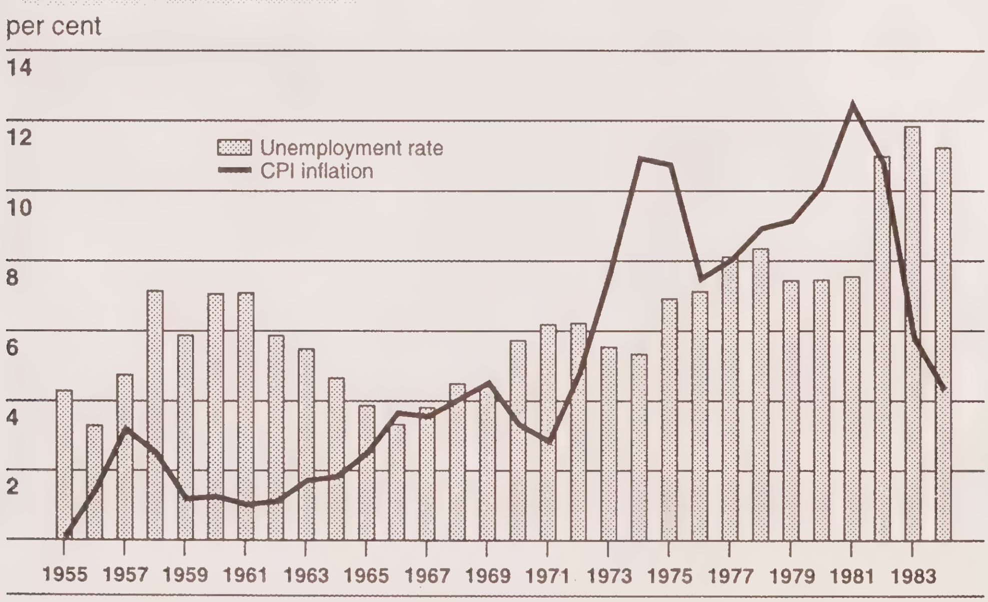
In trying to stimulate growth and lower unemployment, government policy became overly expansionary. This was a mistake. In the early 1970s, inflation soared to 10.9 per cent – up 8 percentage points in only three years. But the unemployment rate did not fall; by the second half of the 1970s, it was rising (Chart 1.4).

This period of both high inflation and rising unemployment, called "stagflation" at the time, was not well understood by governments. Rather than treating the problem as one of excess demand and entrenched inflation expectations, they tried to avoid restricting demand. Instead, they tried to lower inflation directly using policies ranging from inflation guidelines to a temporary system of comprehensive wage and price controls. But the root problem of excess demand and entrenched inflation expectations remained. The policies did not provide a permanent solution. After a brief decline in the mid-1970s, inflation then soared to new heights, reaching 12.4 per cent in 1981, and expectations of continued double-digit inflation became deeply entrenched. But by then unemployment was also much higher.

In the light of the inflation experience of both Canada and other industrialized economies, we now better understand how inflation takes root. There is no long-term trade-off between inflation and unemployment. When demand rises above an economy's ability to produce, inflation goes up and continues to rise until those demand pressures are eliminated. The more entrenched inflation becomes the harder it becomes to get rid of it.

In retrospect, slower growth than in the 1960s and early 1970s reflected slowing growth in productivity and potential output. The drift upwards in unemployment rates in Canada over the 1970s and early 1980s reflected, in part, massive structural changes in Canadian labour markets as participation rates for youths and women soared and as the baby-boom generation entered the labour market. It also reflected the introduction of much more

Chart 1.4
Evolution of inflation and unemployment in Canada 1955 to 1984



generous unemployment insurance in 1971. The Macdonald Royal Commission on the *Economic Union and Development Prospects for Canada* estimated that the 1971 reforms added one to two percentage points to Canada's structural unemployment rate – the rate below which inflation pressures arise.

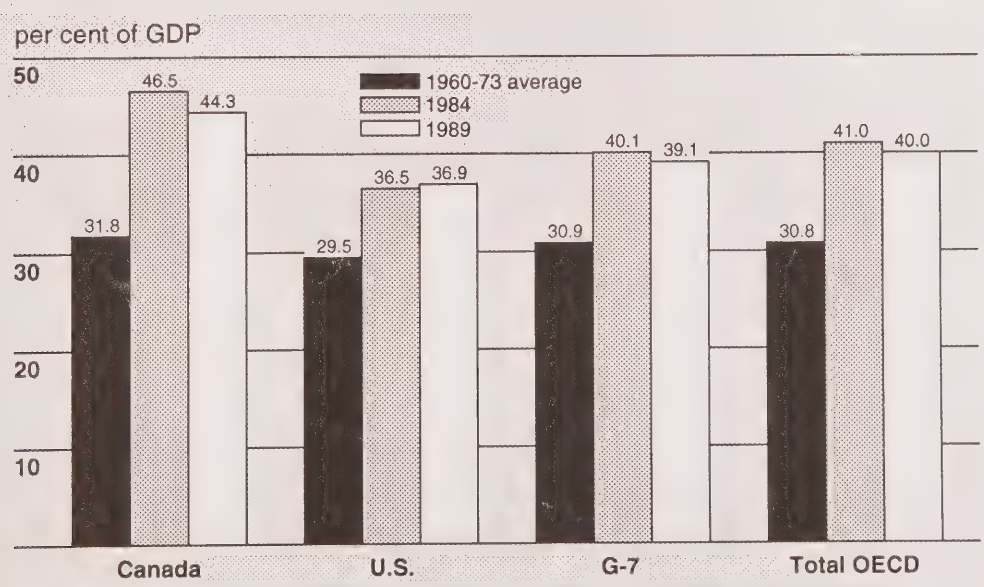
The absence of a trade-off between inflation and unemployment and the obvious high costs, in terms of unemployment and under-utilization of capital, required to eliminate entrenched inflation can lead to only one conclusion: the best policy is to get rid of inflation and not let it rise again.

Losing fiscal control

The penalty of postponing problems became most apparent for fiscal policy. Deficits were allowed to rise and stay high and debt ballooned out of control. From the mid-1970s to the mid-1980s, public expenditures grew much faster than the economy could support. By 1984, total government program expenditures (expenditures before interest payments) had risen to nearly 39 per cent of GDP and total government spending, including interest, reached nearly 47 per cent of GDP – well above the average for the G-7 economies (Chart 1.5).

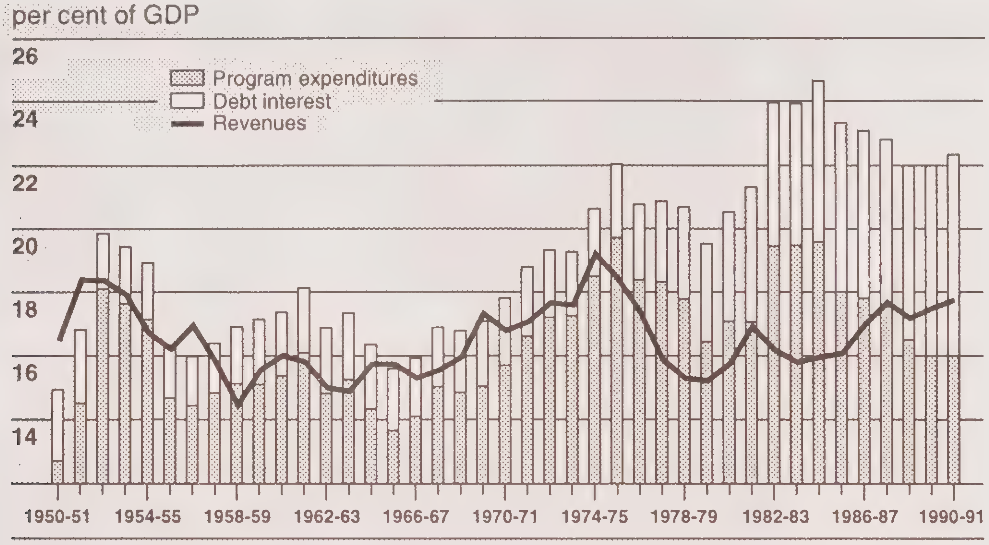
Federal program spending soared, growing 12.0 per cent a year from 1974-75 to 1984-85. Program spending rose to 19.6 per cent of GDP while revenues as a share of GDP were allowed to slip (Chart 1.6). The operating balance went into deficit in 1975-76 after 11 years of surplus. By fiscal year 1984-85, this deficit was $16 billion and for every dollar of tax revenues, the federal government spent $1.33 on programs.

Chart 1.5
International comparisons of size of general government



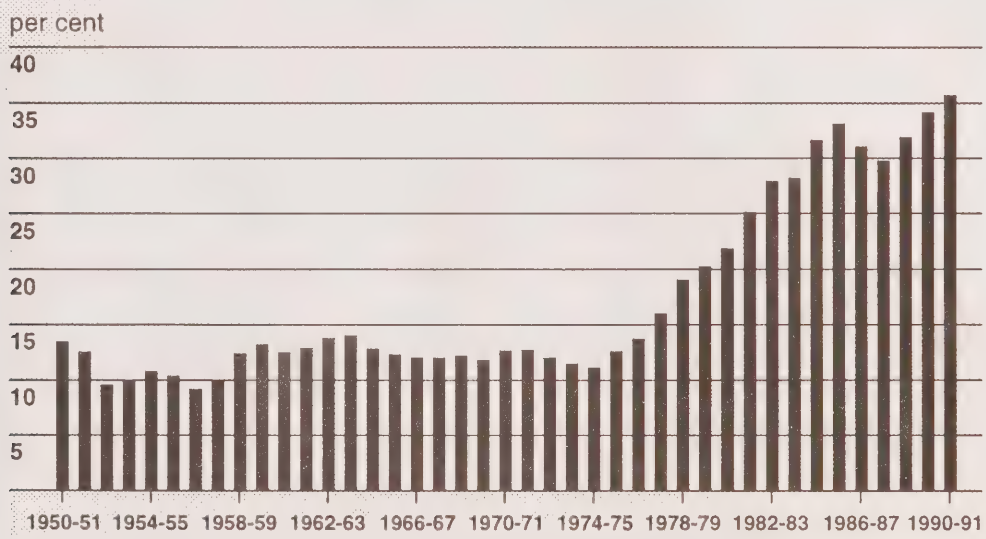
Sources: OECD Economic Outlook, DRI Canada, Department of Finance.

Chart 1.6
Federal revenue and expenditure shares of GDP
Public Accounts basis



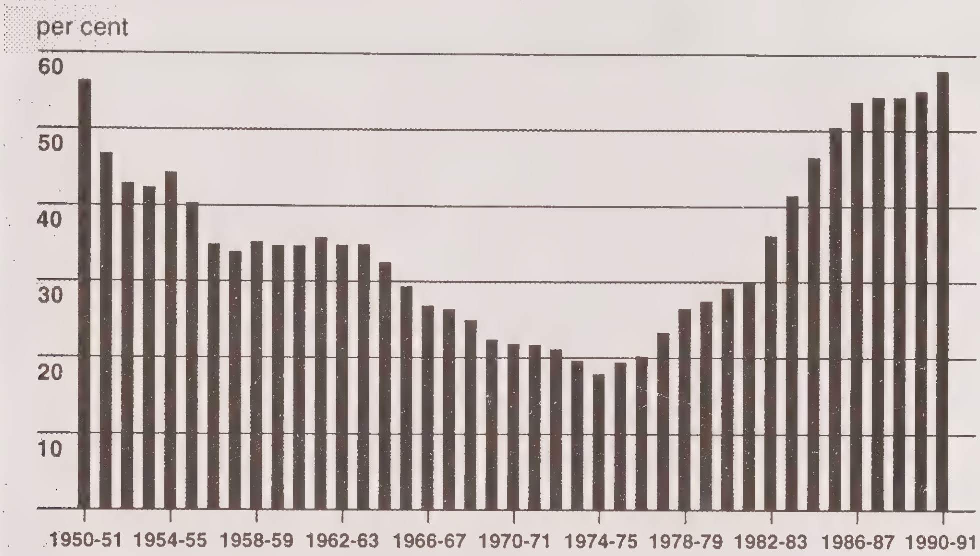
Source: Department of Finance.

Chart 1.7
Share of federal interest payments in total revenue
Public Accounts basis



Source: Department of Finance.

Chart 1.8
Net federal debt as a share of GDP



Source: Department of Finance.

The combination of rising operating deficits and rising interest costs resulting from high inflation and interest rates marked the end of more than two decades of government paying its way. The federal deficit soared to a peak of 8.7 per cent of GDP by 1984-85, over six times the level in 1974-75. Not only were governments borrowing to finance consumption, they were borrowing to service the growing debt. More and more revenue went to pay interest costs only (Chart 1.7).

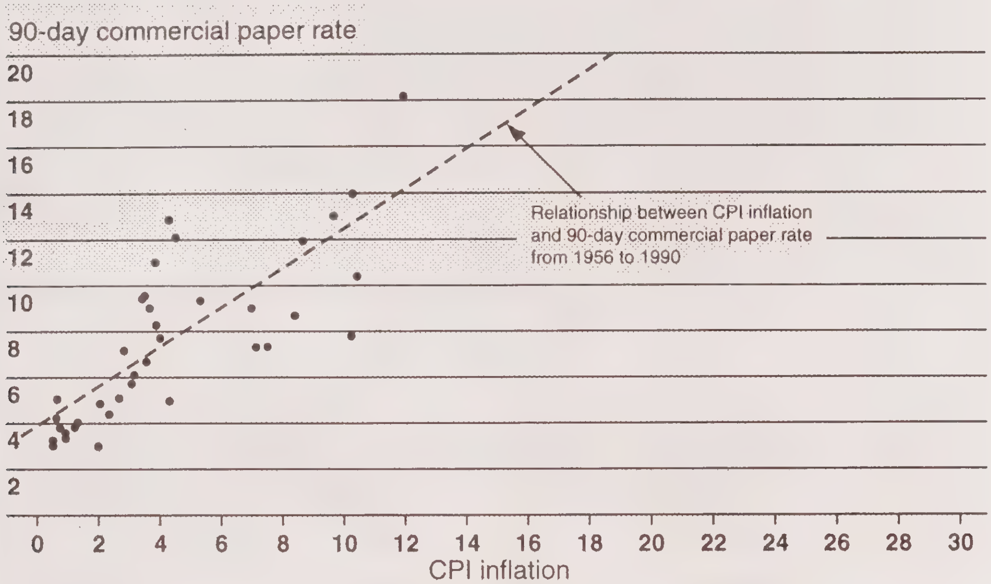
The ratio of federal debt to GDP soared, rising to 46.4 per cent of GDP by 1984-85 (Chart 1.8). The debt share was more than double that in 1974-75 and a return to the level of the early 1950s when Canada was still carrying the huge debts from the Great Depression and Second World War. Twenty-five years of progress in lowering the debt had been thrown away in only one decade.

The cost – Poor economic performance

The failure to contain and lower inflation pressures had many adverse consequences. As inflation rose, lenders sought higher returns to compensate for the expected loss of purchasing power of their investment. Interest rates were bid up (Chart 1.9). Short-term interest rates eventually reached an unprecedented 22 per cent.

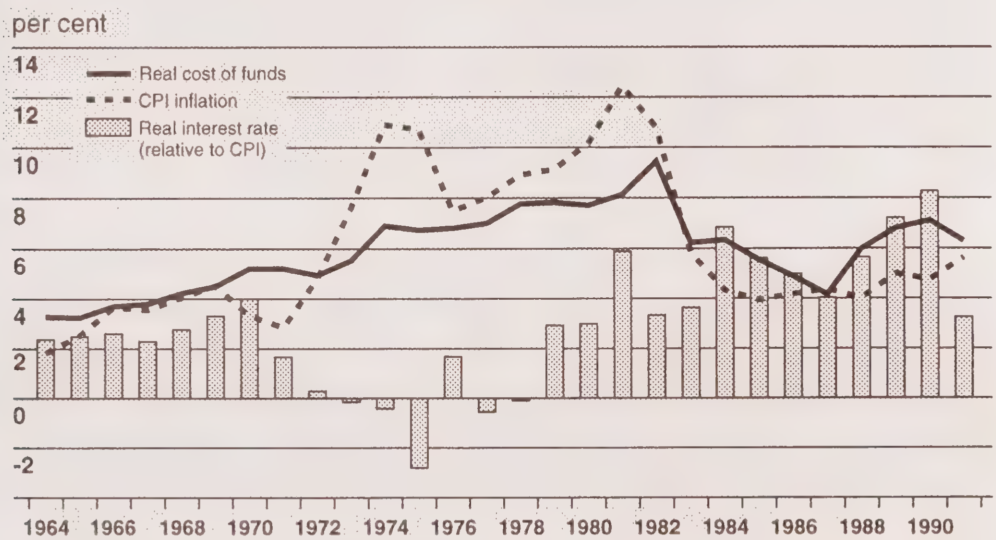
High and uncertain inflation expectations also led to higher risk. Part of this risk came from uncertainty about policy which changed constantly. One year, government tried to stimulate the economy to fight unemployment. The next, it tried to slow the economy to fight inflation. As a result, the real cost of investment capital in Canada rose from around 5 per cent in the early 1970s to a peak of 9.4 per cent in 1982 largely because of an increase in the economy-wide risk premium (Chart 1.10).

Chart 1.9
CPI inflation and 90-day paper rate in Canada, 1956 to 1990



Sources: Statistics Canada and Bank of Canada.

Chart 1.10
Inflation, real interest rates, and the real cost of funds in Canada



Sources: Department of Finance, Statistics Canada and Bank of Canada.

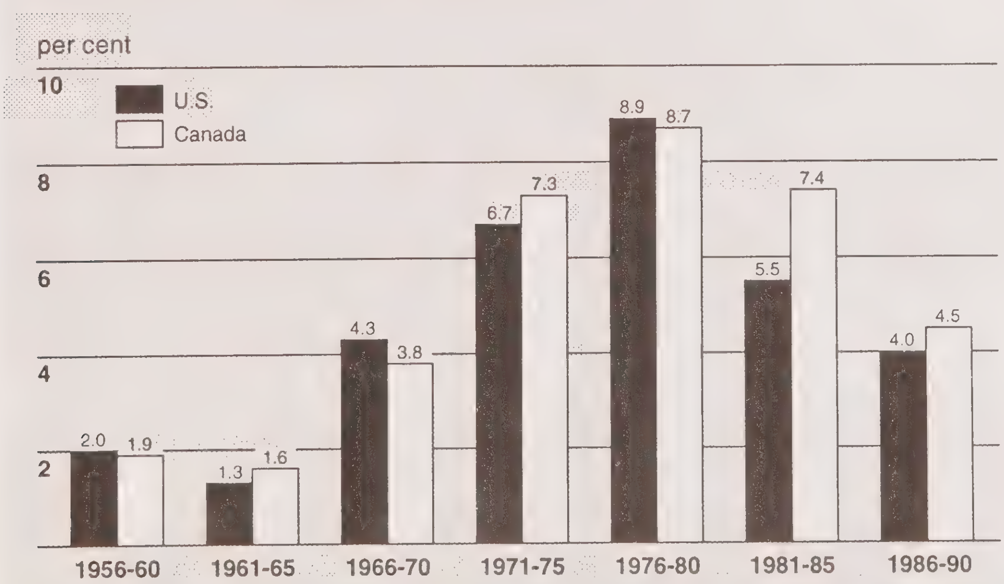
Rising inflation also distorted our tax system and investment decisions. More and more investments were made to achieve a quick payoff or to exploit inflation-driven distortions in the tax system. The country was missing out on investments in the capital needed to enhance productivity and meet our competitive challenges.

By the early 1980s, inflation became regularly higher than in our major trading partners, undermining business confidence and our competitive position (Chart 1.11). To offset the deteriorating competitive position, Canada relied on a falling currency. But the falling dollar only fanned the inflationary flames. It did nothing to solve the root problem of excessive growth in costs and a stagnating productivity performance.

High inflation had a heavy social cost as well as a heavy economic cost. It added to labour-management conflict as firms' owners and workers sought to protect real returns or incomes against high and unstable prices. Strikes became more common; the number of person-days lost to strikes was at record levels in the late 1970s and early 1980s. High inflation also redistributed income but not according to merit. Some Canadians obtained an enormous benefit in the 1970s and 1980s because by chance they had 30-year mortgages at low interest rates. But others saw inflation erode the value of pensions and fixed incomes. The average inflation rate of 9.0 per cent from 1974 to 1984 would halve the real value of fixed income in a scant eight years. In the end, those least able to protect themselves paid a heavy price.

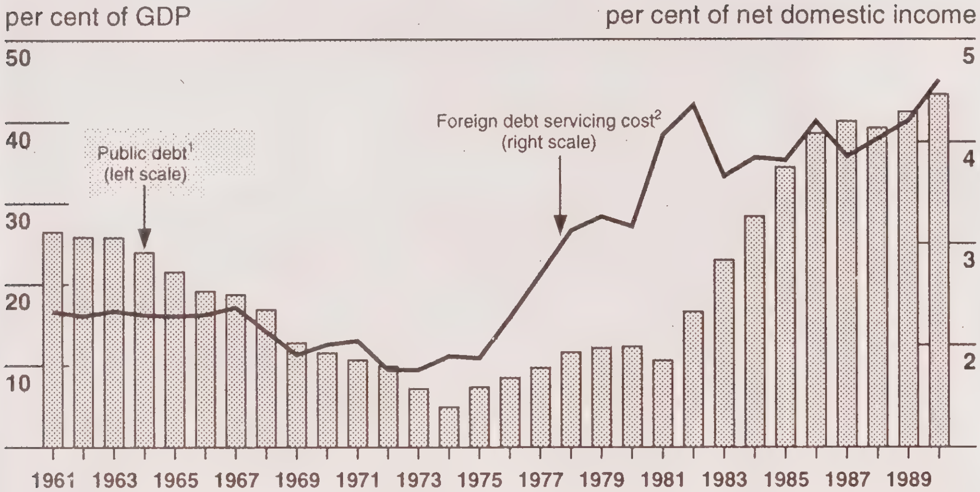
High inflation also had a fiscal cost. Rising interest rates worsened the fiscal position of increasingly indebted governments. With such high deficits and debt, the nation's finances became increasingly hostage to fluctuations in world interest rates. In the early 1970s, a one percentage point increase in interest rates would have eventually raised the

Chart 1.11
CPI inflation in Canada and the U.S.



Sources: Statistics Canada and DRI Canada.

Chart 1.12
Fiscal debt-to-GDP ratio and cost of servicing the foreign debt



[1] Total government debt on a National Accounts basis as a share of GDP.

[2] Difference between net domestic and national income as a share of NDI.

debt-servicing costs of the federal government by roughly $200 million; by 1985, that same one percentage point increase would have raised the federal deficit by over $2.0 billion – a tenfold increase. Eventually, governments had to squeeze spending and raise new taxes just to pay the interest on each year's new debt. By fiscal year 1985-86, one in every three dollars of federal revenue went to interest on existing debt. The government's flexibility to respond was reduced. Governments were increasingly unable to pay for new initiatives and needed investments.

Rising deficits and debt were not just a fiscal problem. The increasing deficit was a direct drain on Canadian savings. More and more investment in Canada was financed by foreign savings and foreign indebtedness rose with government debt. The result was that more and more of the income produced in Canada went to service foreign debt rather than support domestic consumption. By 1984, the share of domestic income going to service foreign indebtedness was over 3 per cent, double the 1950-74 average (Chart 1.12).

In the end, focusing on the short term and postponing tough decisions proved futile. Inflation more than trebled from an annual average of 2.8 per cent in the period 1950-1973 to 9.0 per cent in 1974-1984 and peaked at 12.4 per cent in 1981. Attacking entrenched inflation at its root ended in a severe recession. As a result, the annual unemployment rate rose to an average of 8.4 per cent from 1974 to 1984 and a peak of 12.8 per cent at the end of 1982. There was thus no trade-off of inflation for jobs as had been thought. Productivity and GDP growth slowed substantially. By 1984, the deficit became structural and the government lost its ability to respond effectively to the needs of Canadians. Canada was left with a legacy of domestic and foreign debt that is still with us today.

Policy direction since 1984

In 1984, the government faced the necessity of dealing with these problems and reversing the costly course on which the economy had been allowed to drift. *A New Direction for Canada: An Agenda for Economic Renewal*, set out the new strategy. The Agenda shifted policy thinking to a longer view. It established consistent medium-term targets and outlined some of the key medium-term policies needed to meet them.

The building blocks of the 1984 Agenda strategy were:

- **restoring macroeconomic balance** – by reducing fiscal deficits and controlling and lowering inflation;
- **reorienting framework policies toward promotion of sustainable, medium-term growth** – with measures designed to reduce the role of government in the economy, encourage adjustment, reform the tax system, establish more secure and open trading relationships for Canada, and promote key investments in training, advanced education, research and development, and economic infrastructure.

These policy lines were interrelated. Achieving one would help achieve the others. In particular, the macroeconomic environment had to be made more favourable to private-sector confidence for the framework policies to work. And the structural changes were the key to expanding Canada's potential output.

These policies were particularly hard to undertake because changes of such magnitude create significant transitional adjustment costs for business, labour, governments, and people and the benefits can take time to be realized. But the international and domestic record shows that the alternative – postponing acting – only makes problems worse. A closer examination of the reasons for the 1984 policies and the progress made so far in achieving the medium-term goals of the *Agenda for Economic Renewal* follows.

Restoring macroeconomic balance

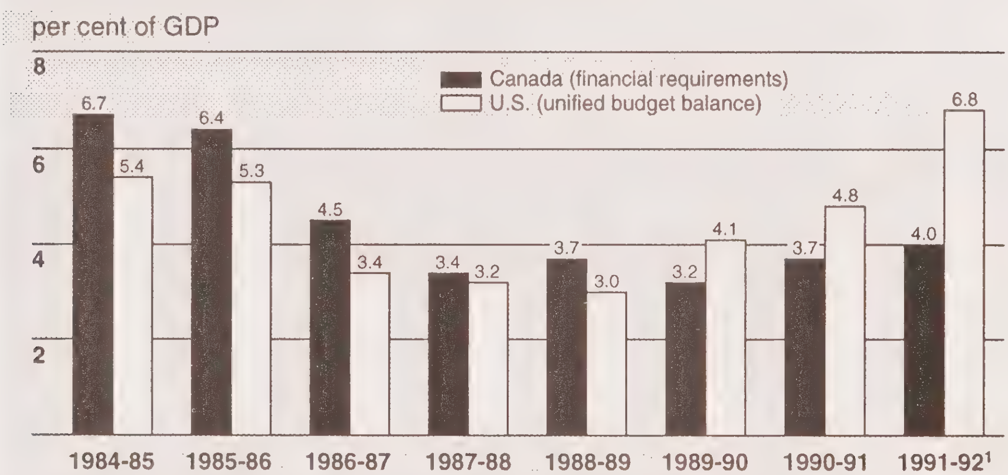
Eliminating fiscal deficits

By late 1984, the first task for government was to restore a better fiscal balance. The nation's finances were mired in deficits and debt. The deficit was 8.7 per cent of GDP. The public debt was growing at a rate of 20 per cent per year. If revenues and program spending as a per cent of GDP had been allowed to remain at their levels in 1984-85, the 1990-91 deficit would have risen from $30.5 billion to $82.7 billion. Public debt would have been 84 per cent of GDP. Gross public debt charges, abstracting from the adverse reaction from financial markets, would have been $58.4 billion compared to $42.9 billion and would have consumed 54 per cent of every revenue dollar. Expenditures had to be lowered, revenues had to be raised.

Budgets since 1984 have cut the growth of spending and raised the revenue share of GDP to more traditional levels. Substantial progress has been made. The operating deficit of $16 billion in 1984-85 became a large operating surplus of $12 billion by 1990-91. Over two-thirds of this improvement came from restraining the share of program expenditures in GDP. Program expenditures had grown strongly up to the mid-1980s; they have declined substantially in real terms since 1984-85 and are now, relative to GDP, back to the levels of the early 1970s.

Chart 1.13
How compound interest pushed up the debt

Chart 1.14
Canadian and U.S.
federal budget balances as share of GDP



Note: Fiscal years ending March 31 for Canada and September 30 for U.S.

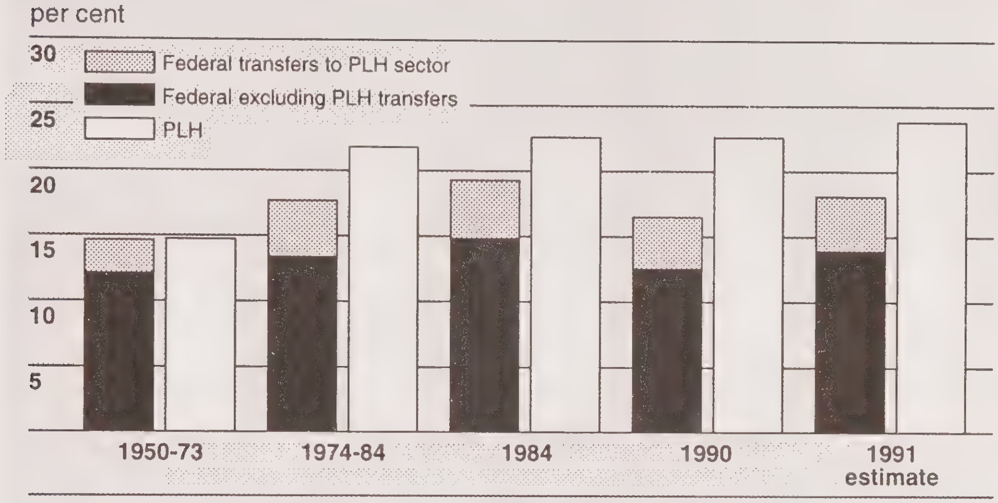
[1] Forecast.

Sources: Department of Finance and U.S. Office of Management and Budget.

Chart 1.15

Shares of federal and PLH government program expenditures in GDP

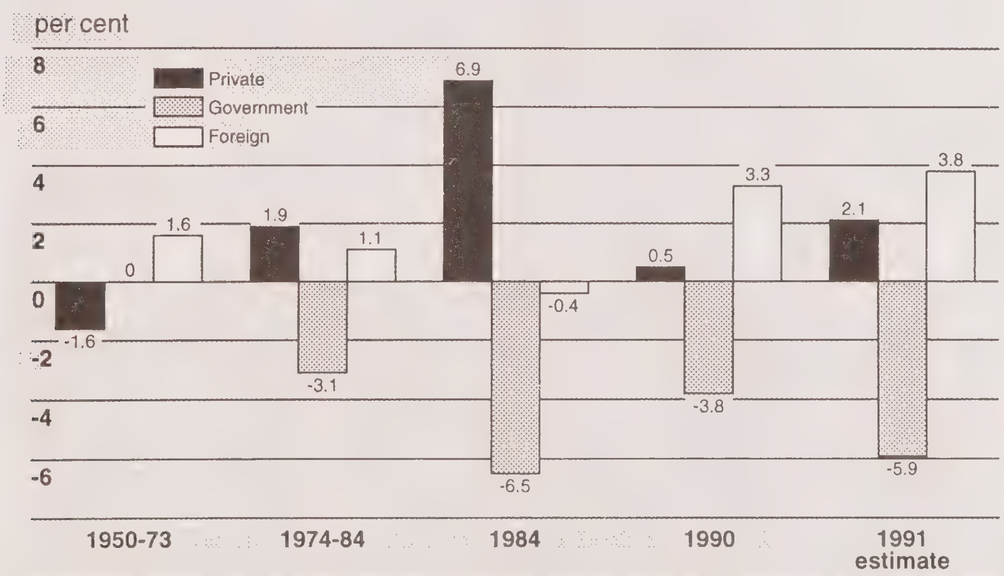
Canadian Income and Expenditure Accounts Basis



Sources : Statistics Canada and Department of Finance.

Chart 1.16

Sources and disposition of savings as share of GDP



Sources: Statistics Canada and Department of Finance.

By 1990-91, the deficit as a share of GDP had been virtually halved from its peak in 1984-85. Although the net debt has more than doubled since 1984, more than all of the increase reflects compound interest on the debt that existed already in 1984 (Chart 1.13).

The changes in expenditure programs and taxes have not been easy for government or the economy and the citizens of Canada. The changes were substantial because the problem was substantial. Government had to both start paying its own way and pay the high interest costs that resulted from not paying its way in the past.

Canada's performance stands in contrast to that of our largest trading partner, the U.S. Canada's federal financial requirements, as a share of GDP, were, until 1988-89, at or above those in the United States. Recently, the relationship started to change. In the U.S., the deficit is 4.8 per cent of GDP and growing (Chart 1.14). According to the U.S. Administration's latest budget proposals it will reach 6.8 per cent of GDP in fiscal year 1992. In Canada, financial requirements will be 4.0 per cent of GDP in 1991-92. On the other hand, the large and growing fiscal deficits of the provinces leave the total Canadian government deficit well above that in the United States.

This shows how the federal government is only one actor, albeit an important one, in achieving the new balance. Even at the beginning of the 1970s, provincial and local governments and hospitals combined (the PLH sector) spent more than the federal government. The gap has increased since then. From 1984-85 to 1990-91, the growth of federal government expenditures on programs averaged 3.6 per cent while that of the PLH sector averaged 7.3 per cent. In 1990, federal program expenditures were less than three-quarters of the PLH level (Chart 1.15).

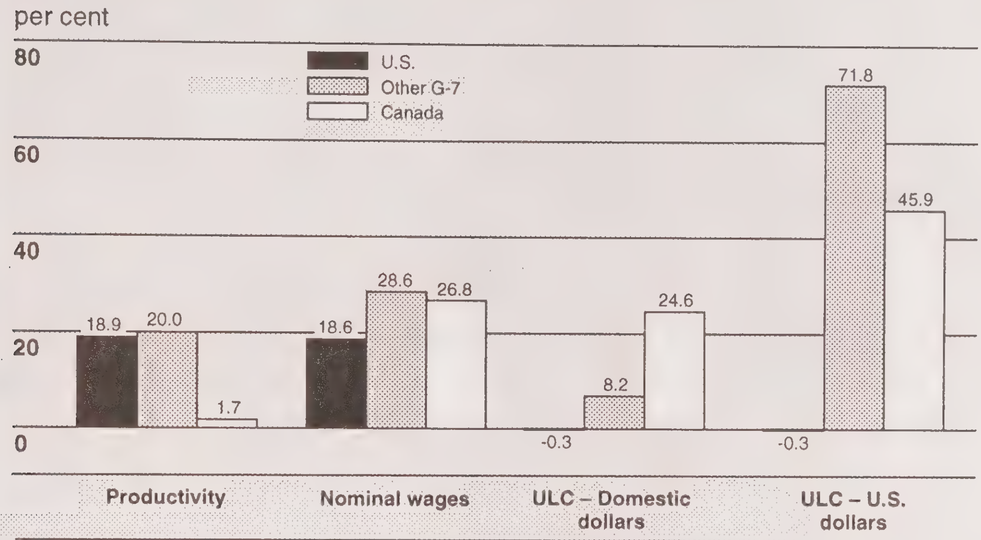
Reducing government dissavings is important, because large government deficits absorb private-sector savings that are better used to finance investment in productivity-enhancing capital. Even if investment can be financed by foreign savings, more and more of our domestic product must go to providing a return to foreign investors, reducing the national income of Canadians. In the 1990s, Canada will need to devote an increasing portion of GDP to investment in physical capital and new technology to keep abreast of major trading partners. Elimination of the fiscal deficit is thus essential to let Canadian savings finance Canadian investment and thus reduce our current account deficit (Chart 1.16).

Eliminating the deficit and lowering our debt is also important to restoring needed fiscal flexibility to the federal government. The high deficits and growing debt of the past decade deprived the federal government of the fiscal flexibility needed to meet new and pressing challenges. The current recession illustrates all too clearly the importance of regaining and maintaining fiscal flexibility. Had more progress been made earlier, Canadian governments would have greater room to manoeuvre now. To regain that flexibility in the 1990s will require continued vigilance. Regaining that flexibility will make us more able to respond to cyclical developments. It will also help meet Canada's competitiveness needs through support for critical investments in training, education, and infrastructure.

Containing and lowering inflation

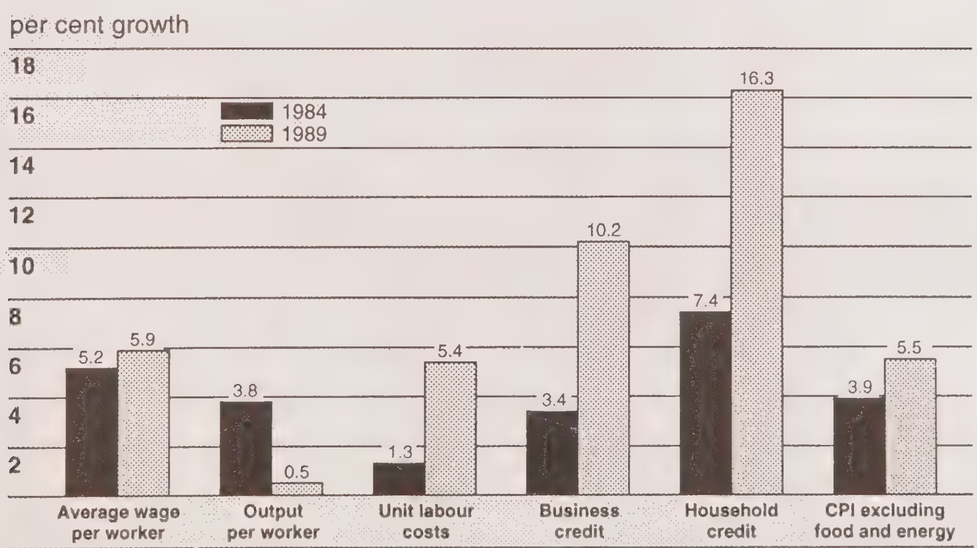
An essential element of the 1984 Agenda was containing and lowering inflation pressures. While, in the aftermath of the 1981-82 recession, inflation had fallen to around 4 per cent in Canada, it was still too high. Moreover, inflation expectations were still deeply entrenched and very sensitive to any increase in inflation. A combination of relatively higher increases in nominal wages and relatively lower increases in labour productivity pushed up Canada's domestic unit labour costs in manufacturing much faster than in the

Chart 1.17
Cumulative growth in components of manufacturing unit labour costs, 1985 to 1990



Source: United States Bureau of Labor Statistics.

Chart 1.18
Indicators of emerging inflation pressures by the late 1980s



Sources: Statistics Canada and Bank of Canada.

U.S. and the other G-7 economies from 1985 to 1990 (Chart 1.17). This comparison makes it clear that the appreciation of the exchange rate was not the fundamental factor creating cost differentials for exporters.

These inflationary pressures became especially evident in the late 1980s, as world resource prices rose sharply and the Canadian economy boomed. Final domestic demand in Canada grew at a 4.9 per cent annual rate from 1985 to 1989, far outstripping growth in Canada's domestic productive capacity and causing a surge in imports. By 1989, growth in business credit had tripled relative to 1984 while growth in household credit had doubled (Chart 1.18). At the same time, growth in labour productivity had slowed markedly while increases in average wages were up. As a result, unit labour costs for the total economy were rising at a rate of 5.4 per cent by 1989 – four times faster than in 1984.

Canadian inflation pressures rose substantially, especially relative to our trading partners. Over the second half of the 1980s, Canada's domestic unit labour costs in manufacturing rose 25 per cent while U.S. domestic unit labour costs did not rise at all. This large gap substantially worsened our competitive position independently of the rise in the dollar.

The Canadian government and the Bank of Canada responded with firm monetary policy and tight fiscal policy aimed at containing and lowering inflation pressures. The commitment to these goals was reinforced in the 1991 budget, which established, in concert with the Bank of Canada, medium-term targets for lowering inflation. A failure to act on inflation pressures would have meant a return to the environment of the 1970s. The lessons of the 1970s showed that there was no benefit to not controlling inflation – indeed there were high and enduring costs – and that postponing the solution only necessitated greater action at a later date.

With monetary policy remaining firm, real interest rates and the Canadian dollar rose, helping to contain inflation pressures. Without the appreciation of the dollar, inflation could easily have been a percentage point or more higher every year than it was.

The record from the 1950s to the early 1970s shows the payoff from low inflation. Low inflation leads to low interest rates. As the budget economic projections show, getting inflation down to rates not seen since the late 1960s and early 1970s will lower interest rates to levels not seen since then. The payoff is already emerging. Short-term rates have fallen by 670 basis points since May of 1990. The prime rate is 7.5 per cent, its lowest level since April 1973. Among the G-7 economies, only the United States and Japan have lower nominal rates. Long-term rates, an indicator of inflation expectations, have also fallen sharply and are down 255 basis points from their levels in the Fall of 1990.

Lower inflation also lowers the real cost of capital for investment. The risk premium on the real cost of funds for investors is highly correlated with the inflation rate. The higher inflation is, the riskier investments become to lenders and the greater the return they demand. This is an important reason why Japan and Germany have had a low real cost of funds for investment: they have achieved and maintained low inflation.

The payoff for economies with a low real cost of funds is that longer-term investments, those that would become riskier if inflation expectations were uncertain, are more attractive. The benefits of such long-term, "patient" investments are evident in strong R&D spending and productivity growth in Japan and Germany. To achieve a similar low real cost of funds in Canada will encourage much-needed, long-term investment and stronger productivity growth.

Reorienting framework policies

The 1984 Agenda also set out to improve the structural framework affecting the Canadian economy. This was particularly so where the opportunities and challenges posed by globalization really mattered.

Securing and enhancing trade

The first step was to secure Canada's access to trade and then expand that access. The Canada-U.S. Free Trade Agreement was launched. It gives Canada access to a large market, something our competitors – the United States, Japan, Germany – already had. It also established a dispute-settlement mechanism which helps protect Canada's interests from U.S. protectionism. The huge market creates opportunities for Canadian firms to adopt leading-edge technologies and rationalize their production. It also gives Canadian consumers access to greater choice at lower cost.

There was and still is no alternative to the FTA. At the time, the United States was becoming increasingly protectionist. Without the FTA, Canada's ability to protect its considerable trade interests could easily have been diminished. As well, at that time, the prospects for successful multilateral trade negotiations were uncertain. These negotiations have yet to achieve success.

In the 1990s, the improvements in Canada's inflation and fiscal performance *vis-à-vis* the United States will allow the FTA to pay large dividends for Canadians. The FTA will become a cornerstone of strong growth.

Canada has also entered negotiations with Mexico and the United States to establish a North American Free Trade Agreement (NAFTA). Canada's participation in these negotiations will help Canada compete with Mexico where it matters the most – in United States markets. It will ensure that Canada stays as attractive as the United States as a place to invest for supplying the entire North American market.

Canada is also a strong supporter of the Uruguay Round of the GATT. Successful conclusion of this round will help lay a foundation for growth in the entire world economy in the 1990s. Any gains made in this round will build on those already achieved through the Canada-U.S. FTA.

Modernizing the tax system

Tax reform was also a critical element of those new framework policies. The first step, income tax reform, created a tax environment that allows higher rewards for success. A new tax system of broader bases and lower rates has replaced the old one of narrower bases and higher rates. The system is now fairer, less distortionary, and helps Canadian corporations compete around the world.

The second step, the replacement of the antiquated and anti-competitive manufacturers' sales tax with the Goods and Services Tax (GST), also broadened the tax base and lowered the rate. Sales tax reform has removed significant distortions in our tax structure, distortions that actually disadvantaged Canadian firms in exporting or competing against imports. It has also stemmed the strong erosion of the federal government's tax base which was occurring under the old manufacturers' sales tax. To stick with the old system was not a choice; it had to be replaced.

Increasing support for training

Unemployment insurance reform has maintained the safety net for Canadians in need of work but reduced disincentives to take available jobs. Support for unemployed workers has been partly redirected to training and skills development through the Canadian Jobs Strategy (CJS), and the Labour Force Development Strategy (LFDS). As well, the Labour Force Development Board (LFDB) was established to unite labour and business in advising the government on priorities for training and employment policies and programs. In 1992 alone, the government plans to spend $1.6 billion on improving the skills of Canadian workers through the CJS and another $1.8 billion through the LFDS. The latter is a sharp increase in the development use of unemployment insurance funds from only $500 million in 1990.

Supporting research and development

The government has provided strong support for investments in Canadian research and development despite the reduction in fiscal flexibility caused by the huge deficit and debt. Canada's overall spending support of science and technology has been extensive, more than keeping pace with inflation. Increases for the high-technology Canadian Space Plan have been particularly strong. In total, federal support for science and technology has gone up 5.5 per cent a year, from $3.7 billion in 1984-85 to $5.3 billion in 1990-91. Public expenditure on non-defence R&D as a share of GDP matches the average for major Organization for Economic Co-operation and Development (OECD) economies.

As well, studies by the Conference Board of Canada and Deloitte & Touche show that Canada's R&D tax incentives are the most generous among the industrialized economies and have made after-tax R&D costs lower in Canada than in the United States.

At the same time, the government has established new organizations to improve the setting of priorities and use of resources in science and technology. These include the National Advisory Board on Science and Technology (NABST), which gives the Prime Minister top-quality advice, and Centres of Excellence that concentrate Canada's best scientific resources into clusters of world-class expertise.

Encouraging competition

There have been other important framework policies:

- The government has reduced its role in the economy through deregulation and privatization, particularly in areas where greater efficiency benefits the whole economy, such as energy and transportation.
- The rules governing Canada's federally regulated financial institutions have been reformed. These reforms will benefit consumers by increasing competition and the spectrum of services offered by financial institutions.
- The introduction of a modern *Competition Act* in 1986, after decades of indecision, encourages greater competition within Canada to spur enterprise.
- The government has reformed Canada's private pension system, giving employees more equitable access to tax-sheltered savings for retirement and encouraging higher savings.
- The government also modernized delivery of support for regional development. The creation of the Atlantic Canada Opportunities Agency (ACOA) and the Department of Western Economic Diversification (WD) ensured that development decisions would be made in those regions themselves. As well, the February 1990 budget introduced a

repayable-contributions policy for all contributions to business. These changes will encourage more responsible decisions and a better return on investments.

CANADA IN THE 1990s

The economy today

By the late 1980s, the economy was beginning to expand too rapidly. Inflation pressure emerged and our competitive position weakened. The government responded to these inflation pressures with tighter fiscal and monetary policies. Growth fell and the economy went into a recession which was exacerbated by a recession in the United States and a slow adjustment of inflation pressures in Canada.

The recession has been painful. But the alternative – waiting until later to deal with inflation and the deficit – would have only worsened our situation. And the price of waiting would have been a deeper, more prolonged recession. By sticking to our deficit goals and containing and lowering inflation Canada is well-placed to achieve a strong, sustainable recovery.

Now, early in 1992, that recovery is being inhibited by a weaker-than-expected world economy and global restructuring. This has dealt a blow to confidence in Canada and elsewhere. Canada's high reliance on exports means that when our trading partners' economies are weak, our economy is also weak. The weakness of the recovery in Canada also reflects the large build-up in household debt over the 1980s. While much debt was more than matched by growth in assets, both physical and financial, households find themselves short of liquidity or ready cash. In the face of an uncertain future they are cutting back on all but essential spending and trying to rebuild healthy financial positions.

Part of this weakness also reflects the difficulties of adapting to the needed policy changes put in place in the late 1980s. Adapting to any of these changes by themselves would not have been easy. Adapting to all of them was an enormous challenge for Canadians.

Yet, the economy will recover. And Canada has made a substantial down payment on a better economic performance in the 1990s. On the microeconomic front, progress has been made in reducing the role of government in the economy, putting in place needed structural reforms and encouraging more rapid adjustment to competitive challenges. On the macroeconomic front, inflation and interest rates are down sharply, and will fall further, and the fiscal structure is in place to eliminate new borrowing by the mid-1990s. The economy will recover in 1992 and grow strongly thereafter.

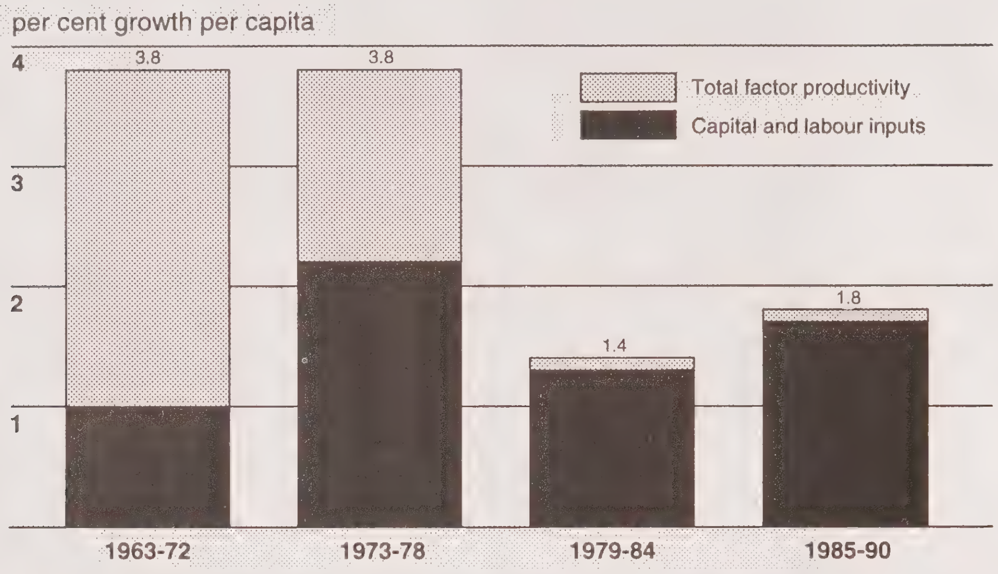
The productivity challenge

But, Canada can and must better its poor productivity record if we are to further improve our living standards and maintain our generous social safety net.

The cost of this poor productivity record is evident in slowing growth in incomes. From 1963 to 1973, real net national income per capita – the income left to Canadians after servicing our foreign debts – grew at a rapid pace of 3.8 per cent a year. By the late 1970s and early 1980s, this had slowed to 1.4 per cent a year (Chart 1.19).

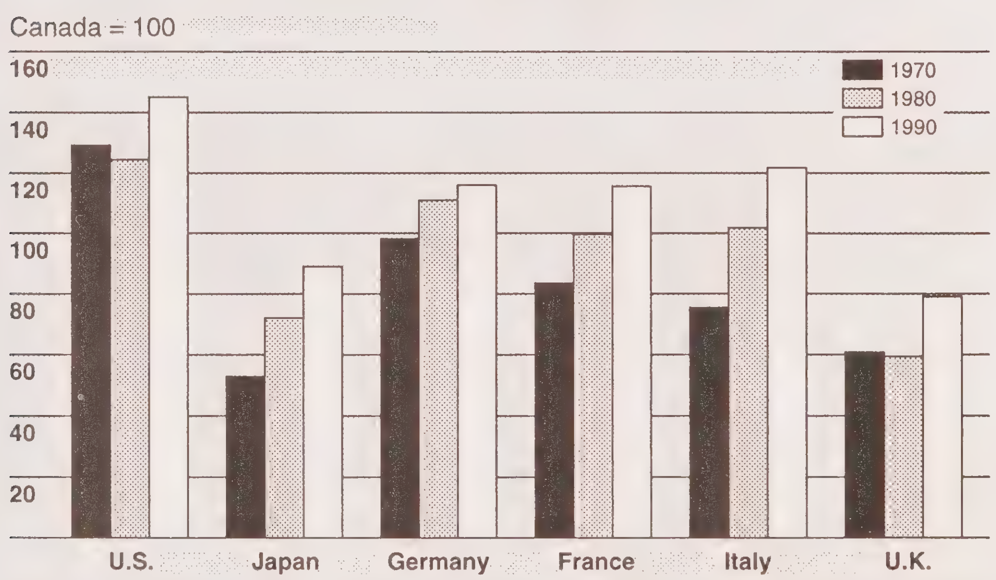
Many Canadians are aware of this slowdown in their everyday life. They feel that their standard of living is not improving as fast as it used to. They wonder why this is so. The answer is simple, although the solution is not. The slowdown results almost exclusively from poor productivity growth in the 1980s. Since the late 1970s, growth in Canada's total

Chart 1.19
Growth of real net national income per capita



Source: Department of Finance estimates.

Chart 1.20
Levels of manufacturing labour productivity



Source: Economic Council, *Pulling Together: Productivity, Innovation and Trade.*

factor productivity (a measure of how efficiently and effectively we are using our labour and capital as well as their quality) has hardly increased – only 0.1 per cent a year. From 1963 to 1972 it increased 2.8 per cent a year. In the 1980s, output rose almost exclusively because we invested more and the labour force grew, not because we worked more efficiently.

As well, in the past, Canada has relied heavily on natural resources for growth in our standard of living. This is becoming increasingly difficult. Real resource prices have fallen by over half since the beginning of the 1980s. They are unlikely to increase substantially in the future as world production becomes more technology-oriented and uses less raw material.

Canada's relative standard of living will fall if its productivity performance does not improve. Other countries will surpass us. This has already happened in labour productivity in manufacturing. In 1970, Canada had the second highest level of output per worker in manufacturing in the G-7. Only the U.S. was higher. By 1980, Germany, France and Italy had reached or slightly surpassed Canada's level. By 1990, they were well ahead. If we stand still, more and more countries will pull ahead (Chart 1.20). If we stand still, we will not be able to maintain our standard of living and our social security system, let alone improve them.

The challenges ahead for the private sector

The record, in both Canada and abroad, shows that it is markets and the private sector which are the engine of growth in productivity. To be that engine, in the face of the global restructuring which is now occurring, Canadian business and labour will have to adopt a new attitude, one which aims at making Canada a producer of high-quality goods and services which can compete anywhere in the world. This will require a strong commitment to investment, R&D, and raising the skills of the workforce.

The record shows that, despite a very generous tax regime, Canadian businesses have failed to invest in research and development to the same extent as in our major trading partners. In manufacturing, it is estimated that only 1,700 of 40,000 firms undertake any R&D at all. Among the G-7, Canada is sixth in the share of research scientists and engineers in its labour force. It also seems that Canadian business is slow to adopt technology which has been proven elsewhere in Canada or the world.

The record also shows that Canadian firms have not invested enough in their labour force. Only one-third of employers provide training for employees and the share of private training in GDP is a fraction of that in economies such as the U.S., Japan and Germany. Canadian businesses too often treat workers as a cost to be minimized rather than an asset to be developed. Firms will have to more closely involve workers in decision making. They will have to work together to improve productivity. Both will benefit.

The challenges ahead for government

To lay the foundation for a sustainable expansion

The first challenge for government is to lay the foundation for a sustainable expansion. This means not choosing a quick fix that would only compromise our future as the policies of the late 1970s and early 1980s compromised our present. It means following consistent policies which contribute to stability and confidence.

In particular, it means sticking with the policies of lowering inflation, returning total government finances to a balanced position, and lowering the total government tax burden. These policies worked before. They underpinned the successes of our economy in the postwar period to the early 1970s.

To enhance competitiveness

The globalization that is now occurring is both a challenge and an opportunity. To meet that challenge government must help create an environment which assists workers and businesses to adapt. There are still too many policies in Canada which discourage firms and workers from adapting to change. There are still too many policies which discourage efforts and reward failure rather than success. These must be changed. Policies must encourage adjustment and create incentives which improve the functioning of the economy.

Elimination of interprovincial barriers to trade would contribute importantly to productivity. There are over 500 such barriers. They make taxpayers and consumers pay more than they should for products and services.

To become more efficient

Government has a key role to play in helping raise Canada's productivity and competitiveness. Government plays a critical role in the economy, through its expenditure, taxation, and regulatory powers. In 1990, total government spending represented over 46 per cent of GDP. If government is inefficient, the effects can ripple through the entire economy.

Government must ensure that resources are effectively employed. Government must, like the private sector, ask itself tough questions about whether it can afford to or should continue doing all it does now. Government must become as efficient and cost effective as possible. Like the private sector, the government must improve the quality and reduce the costs of the goods and services it produces. The access to government services must be improved; the layers and complexity of regulations must be reduced.

To facilitate investment

Another role for government is in investments in productivity-enhancing capital and infrastructure. In many cases, such investments return benefits to all Canadians. Because the benefits are so widespread, the private sector cannot undertake them alone. A partnership between the private sector and government will be needed.

One of the most important investments government can make is in education. Canada's education spending is high by world standards. But doubts are growing that we are getting the best we can from the education dollar. Dropout rates from high school and the results of literacy tests show we must do better.

To develop partnerships

The challenges before Canada remain enormous. If Canadians sit back and wait for someone else to deal with these challenges we will not succeed. If Canadians criticize rather than participate constructively in finding a solution we will not succeed. If we do not succeed we will all pay the price. If we succeed we will all reap the benefits.

What is needed now is co-operation. Business, labour, the voluntary sector, and governments at all levels must forge a renewed partnership and prepare Canada for the

21st century. We must do what our parents did: work together to improve Canada's wealth. They did it and left a better Canada for their children than they inherited. Will we be able to make the same claim?

What is also needed is pride. Canadians must rediscover pride in producing goods and services that can compete with the best the world offers. Canadians must rediscover their pride in being citizens of a country which is the envy of the rest of the world.

CHAPTER 2: CANADA'S ECONOMIC PERFORMANCE AND PROSPECTS

ECONOMIC DEVELOPMENTS IN 1991

The Canadian economy began to emerge from a difficult recession in 1991 but the recovery has not been as strong nor as broadly based as had been expected a year ago. The international economic situation is uncertain and confidence remains weak, not only in Canada but in other major economies as well. At the same time, sharply lower inflation and declines in interest rates, particularly in Canada and the United States, are putting in place the fundamental requirements for stronger economic performance.

Growth resumes in second quarter

The first quarter of 1991 was the fourth consecutive quarter of declining output. It marked the trough of a tough recession, during which real output fell by a total of 2.8 per cent. Although the decline was only about half as severe as the loss of output in the 1981-1982 recession, it was substantial and was accompanied by a 2 per cent drop in employment.

The four quarters of recession were followed by real output growth of 5.7 per cent at an annual rate in the second quarter of 1991. The resumption of growth in the second quarter came earlier than expected and was surprisingly strong. The rate of growth weakened through the second half of the year, however, with growth averaging 3.3 per cent over the second and third quarters and economic performance was essentially flat or slightly negative in the fourth quarter of 1991.

The composition of growth in the early stages of the recovery reflected the response to the sharp lowering of interest rates over the previous 12 months. The resumption in growth was prompted by a revival in the most interest-sensitive components of spending, mainly investment in residential construction and the purchase of durable consumer goods. The total final demand for goods and services produced in Canada (GDP less the change in inventories) grew an average 4.2 per cent at annual rates in the second and third quarters after a cumulative decline of 3.5 per cent during the recession. More than a third of this demand surge was satisfied by drawing down inventories.

Despite the slower start of recovery in the United States and economic slowdown in some of our other major trading partners, exports also made a large contribution to the rebound in the second and third quarters. Real exports increased over 16 per cent, led by automotive exports. Real imports also increased strongly in response to the strength in domestic demand.

Fourth quarter: Deteriorating international economy saps the recovery's strength

In late November, the strength of the recovery in the U.S. economy began to be called into question as the extent of economic restructuring became clearer and consumer confidence declined sharply. The modest growth in the second and third quarters deteriorated unexpectedly and the U.S. economy was flat in the fourth quarter. It grew only 0.3 per cent at annual rates and appears to have begun 1992 on a weak note as well. Developments overseas reinforced the impact of the faltering U.S. economic performance. After a growth surge in the first quarter of the year, the Japanese and western German economies were also surprisingly weak in the second half of 1991.

Chart 2.1
Conference Board of Canada Index of Consumer Attitudes

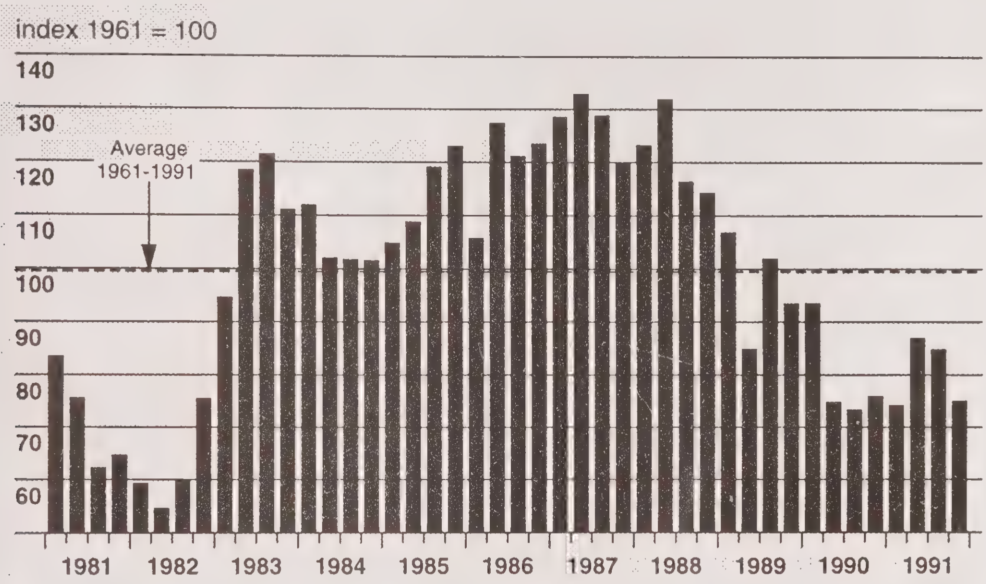
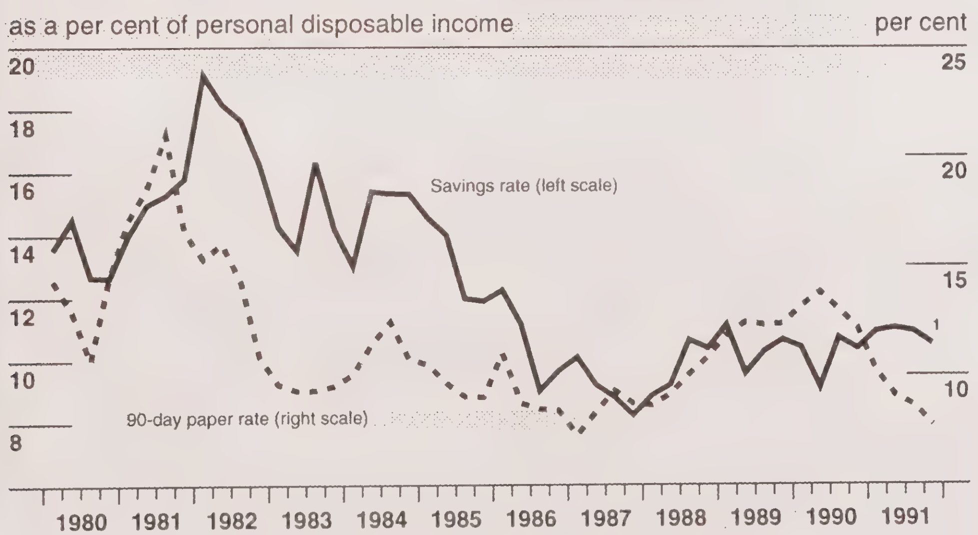


Chart 2.2
Personal savings rate and 90-day commercial paper rate



[1] 1991 fourth quarter value is an estimate.

The unexpected sluggishness of the world economy exerted both direct and indirect pressures on the Canadian economy. The direct impact was evident in Canadian exports, which fell sharply in the fourth quarter. The indirect effects were much more pervasive, however, negatively affecting both household and business sector confidence as the decline in U.S. confidence spilled over into Canada. Consumer confidence had improved through the early part of 1991 but was particularly hard hit later in the year, stalling and then falling back in the fourth quarter (Chart 2.1). The clearest evidence of shaky consumer confidence was the failure of the savings rate to decline appreciably by year-end despite significantly lower interest rates (Chart 2.2). This was also in sharp contrast to the usual cyclical drop in the savings rate in the early quarters of a recovery.

Sluggish employment growth has also prevented consumer confidence from rebounding as it normally would in a recovery. From the trough in February, employment had increased by only 28,000 jobs by year-end, far below the normal cyclical rebound. The result was stubbornly high unemployment, which directly restrains confidence because of the uncertainty it creates about future job prospects.

With falling exports and weaker domestic confidence, Canadian output was likely stagnant or may have declined slightly in the fourth quarter. Consistent with declining consumer confidence, the sharpest deterioration among the components of domestic demand occurred in consumer spending, which appears to have declined marginally compared with earlier strong growth. Only residential investment continued to grow at a strong pace, responding to lower mortgage rates and improved housing affordability.

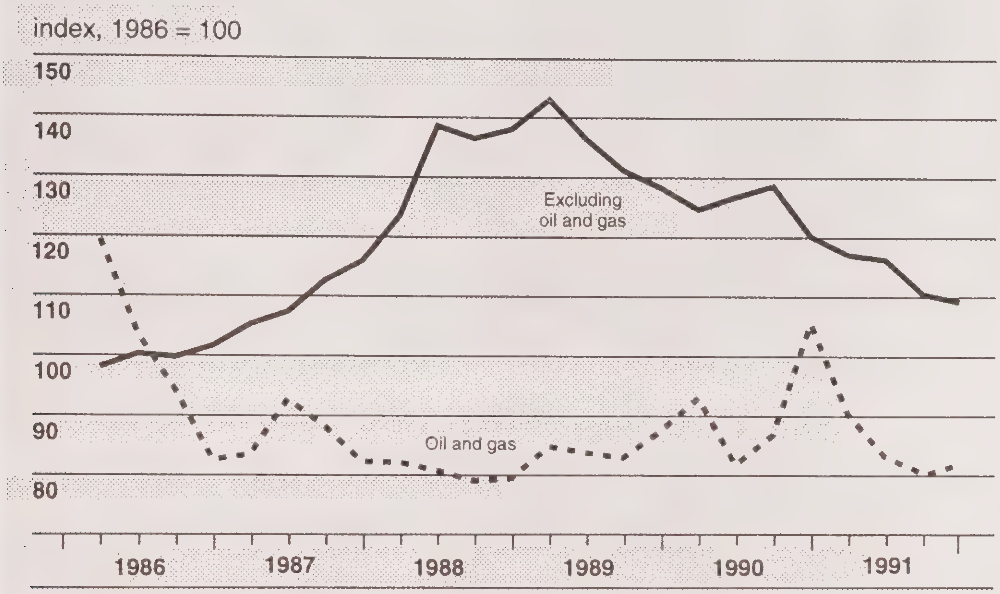
Corporate financial positions deteriorate further in 1991

The sluggishness in the world economy has also led to falling commodity prices (Chart 2.3) and declines in Canada's terms of trade. This has reduced activity and profits in the resource sector. More generally, profit margins (Chart 2.4) declined sharply throughout the economy during the recession, squeezed not only by competitive pressures and weak commodity prices but also by persistently high growth in costs, particularly labour costs.

The strength of the Canadian dollar also intensified the pressure on profits in industries dependent on exports as well as in industries competing with imports. The Canadian dollar rose against its U.S. counterpart through most of 1991 despite the narrowing interest rate differential between Canada and the United States (Chart 2.5). The dollar declined in November and December, however, closing the year at approximately the level at which it began the year. The dollar has continued to ease so far this year, falling back below 85 U.S. cents.

Low profits and accumulating debt resulted in record debt-servicing burdens in the corporate sector by the first quarter of 1991 (Chart 2.6). Profit margins remain extremely low by historical standards, although they have begun to recover from the low established in the first quarter of 1991. Together with declining interest rates, this slight improvement in margins allowed debt charges to decline slightly in the second quarter relative to profits, with further improvement recorded in the second half of the year. This burden continued nonetheless to undermine business confidence and hurt investment throughout 1991 by limiting the availability of internal funds.

Chart 2.3
Commodity prices



Source: Bank of Nova Scotia.

Chart 2.4
Profit margins non-financial corporations

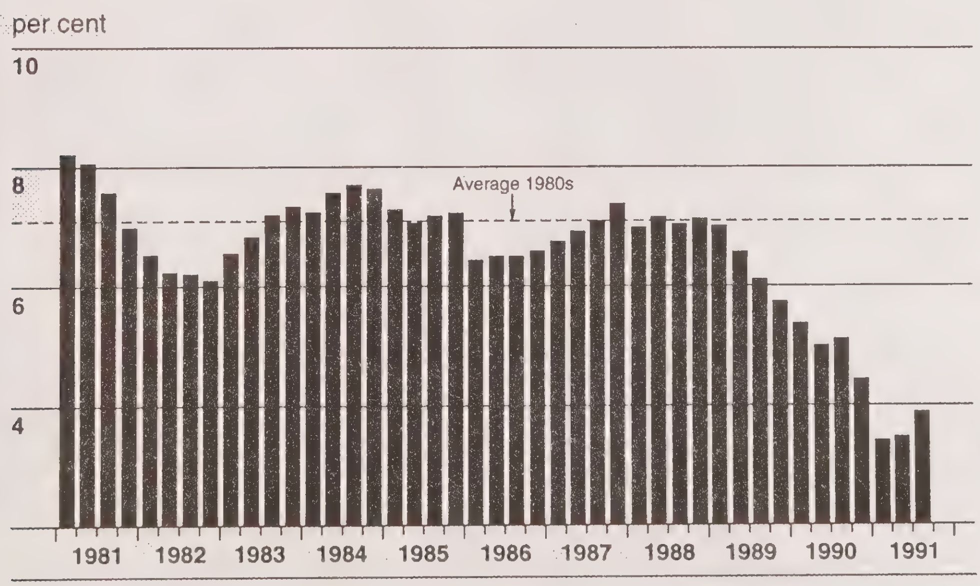
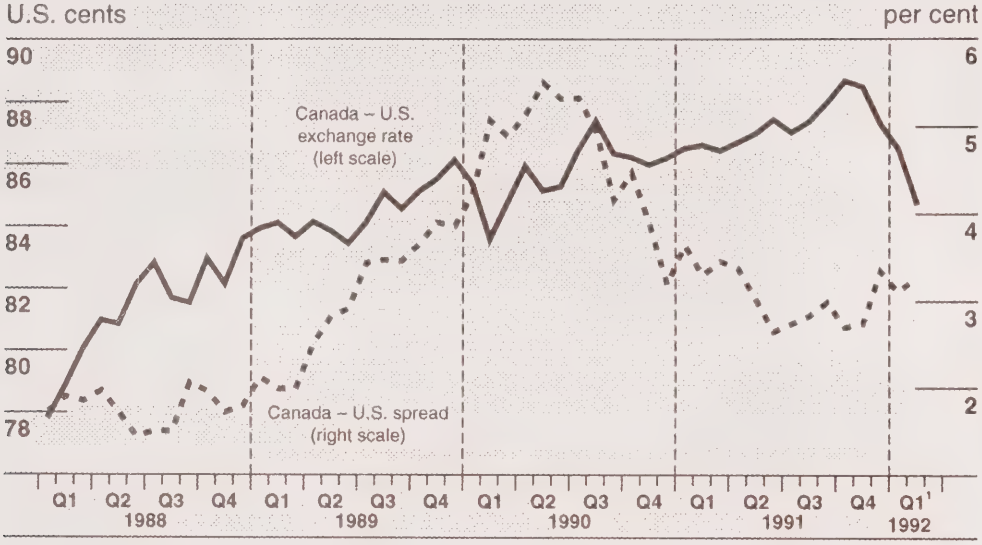
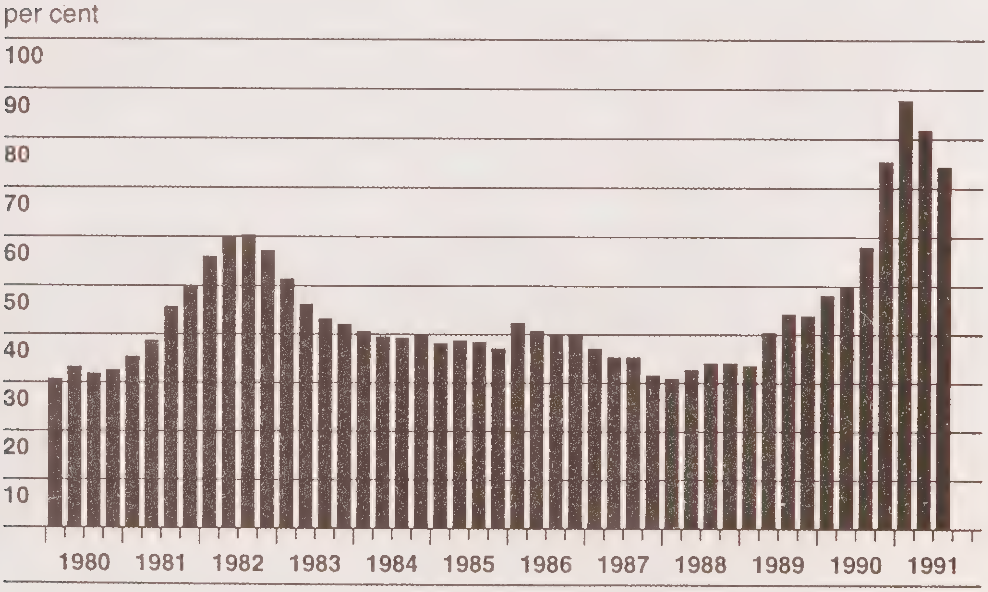


Chart 2.5
Canadian – U.S. exchange rate versus interest rate spread



[1] Data as of February 12, 1992.

Chart 2.6
Debt-servicing burden non-financial corporations



Getting the domestic fundamentals right . . .

The near-term outlook is beginning to improve. As the G-7 Finance Ministers concluded at their January 25 meeting, "the forces that have been inhibiting economic activity in many countries are dissipating and . . . the conditions for improved global growth exist". Low inflation and low interest rates are providing the basis for renewed confidence and growing purchasing power in both the consumer and business sectors.

. . . low inflation

With the increase in inflationary pressures in the late 1980s, it became abundantly clear that permanently lower inflation and inflation expectations were the keys to more sustainable economic performance. Only with permanently lower inflation could interest rates come down and stay down, boosting confidence and stimulating domestic spending. Reducing domestic cost pressures was critical to allow a durable easing in monetary conditions and to achieve the rebuilding of profit margins necessary for a non-inflationary, and therefore sustainable, recovery.

The February 1991 budget addressed the challenge of inflation and inflation pressures.

- The budget established realistic inflation-reduction targets aimed at lowering inflation to 3 per cent by the end of 1992 and less than 2 per cent by the middle of the decade. The targets are a clear signal that the government and the Bank of Canada are committed to price stability. Introduced to speed the adjustment to price stability by dampening inflation expectations, they have successfully done so.
- The government exercised leadership in restraining wages and salaries to help reduce domestic cost pressures. Wages and salaries of federal parliamentarians, public servants and order-in-council appointments were frozen by legislation in this fiscal year and limited to an increase of 3 per cent in the next. Most provincial governments have followed the federal lead in restraining public sector compensation.
- The government reinforced its commitment to move towards a balanced budget to prevent deficits from becoming a source of inflationary expectations and an overbearing competitor for scarce funds in capital markets. The government reaffirmed its commitment, first made in 1989, to reduce financial requirements to zero by 1995. The earlier Expenditure Control Plan, introduced in the February 1990 budget, was extended through fiscal 1994-95. Legislation was proposed to set absolute limits on government program spending for the next five years.

Significant progress was made during 1991 in creating the domestic conditions for a strong recovery: inflation pressures eased substantially through the year, allowing large declines in interest rates. Progress on inflation was hidden by the one-time price level impact of the introduction of the GST. This obscured significant underlying reductions in inflation pressures in response to the slack that had emerged during the recession in product and labour markets. Capacity utilization fell from almost 84 per cent in the second quarter of 1990 to below 78 per cent in the first quarter of 1991. Over the same period, the unemployment rate rose substantially. The continuing appreciation of the Canadian dollar and the sharp decline in oil prices as world markets stabilized in the wake of the Persian Gulf crisis also contributed to the decline in inflation.

The year-over-year inflation rate fell from 6.8 per cent in January last year to 3.8 per cent in December and a remarkable 1.6 per cent in January this year (Chart 2.7). The underlying or core rate of inflation – the consumer price index (CPI) excluding the volatile food and energy components – declined sharply at the same time. The year-over-year rate in

Chart 2.7
CPI inflation rate – all items

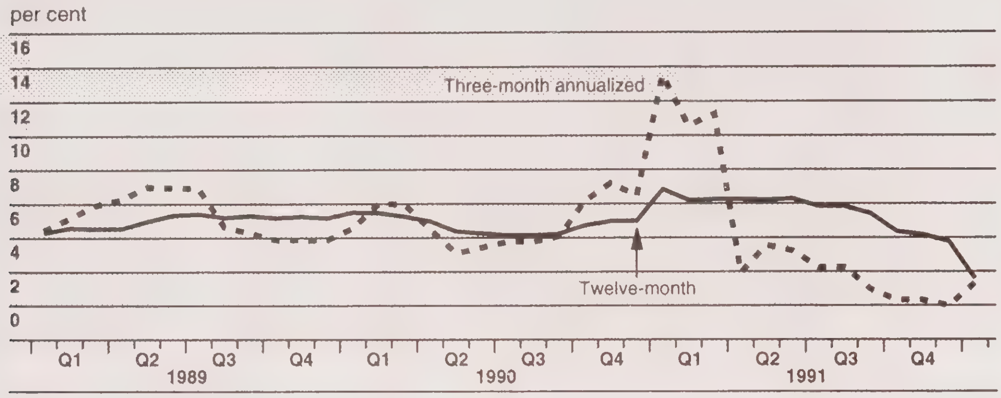
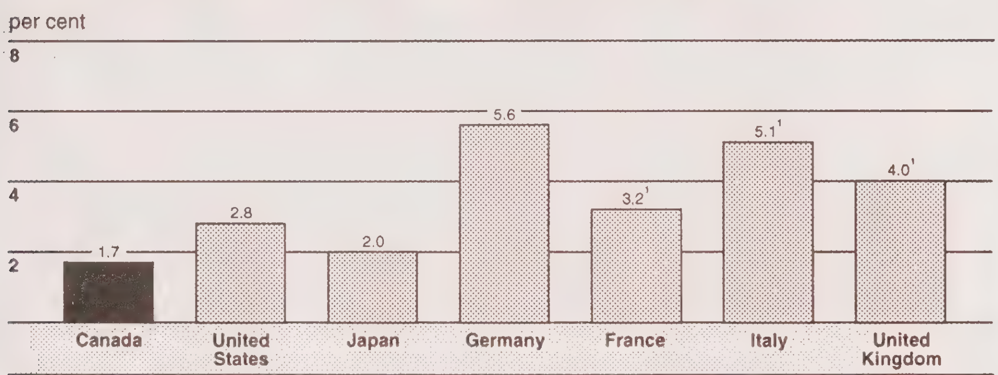


Chart 2.8
Consumer price inflation rates in the second half of 1991



[1] Data are not seasonally adjusted.

Chart 2.9
Private and public sector wage settlements

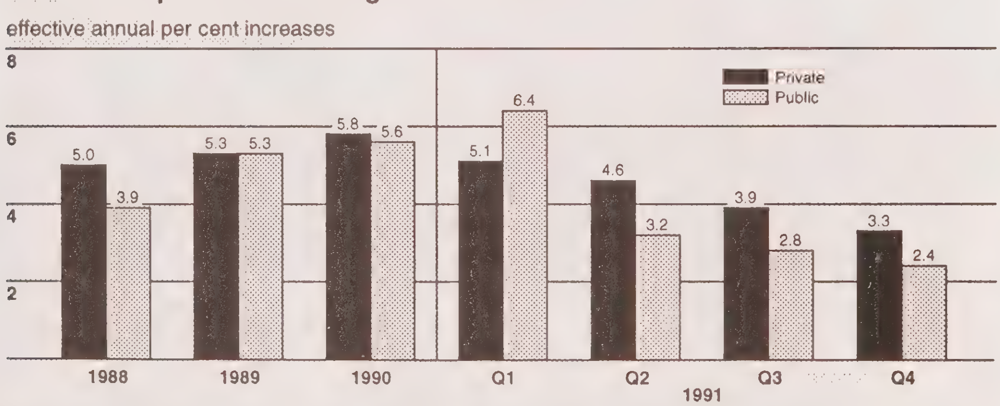


Chart 2.10
Prime rate, one-year mortgage rate and 90-day commercial paper rate

per cent

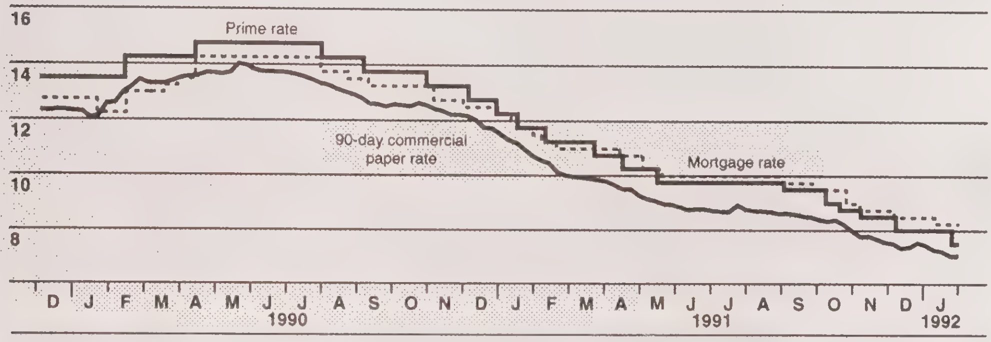
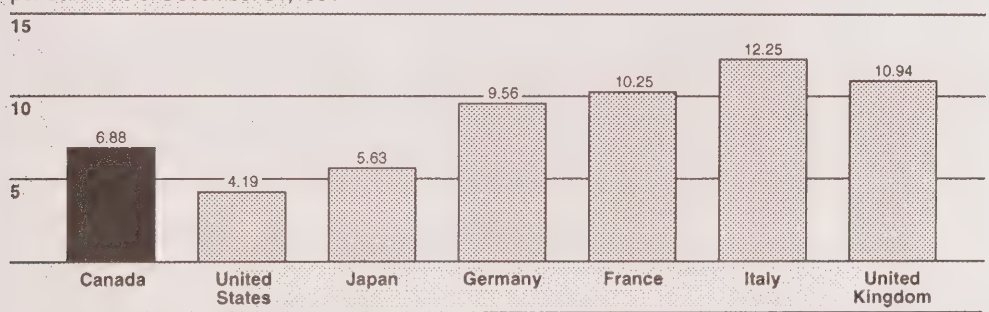


Chart 2.11a
Short-term interest rate comparison
Three-month eurocurrency deposits rates

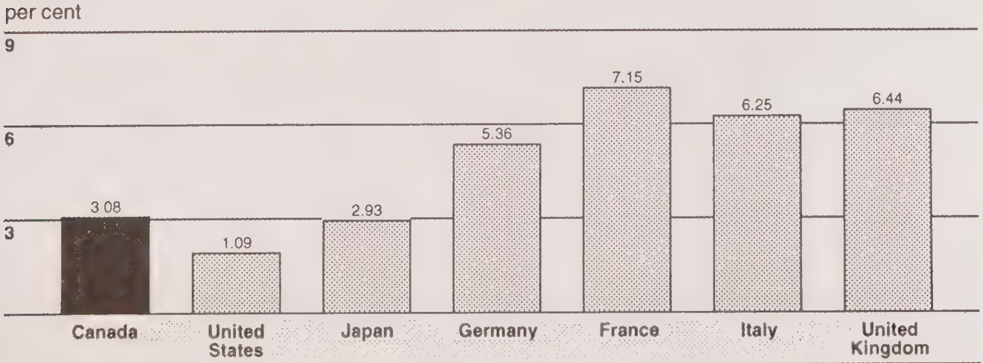
per cent – as of December 31,1991



Source: Financial Times of London.

Chart 2.11b
Real short-term interest rate comparison[1]

per cent



[1] Nominal three-month eurocurrency deposits rates minus CPI inflation in December 1991.

January is Canada's best inflation performance since the early 1970s; it represents a sharp improvement from inflation at a seemingly entrenched 4 to 5 per cent during much of the 1980s. Moreover, on the basis of the second half of 1991, inflation in Canada has now fallen below the rate in the United States as well as all other G-7 countries (Chart 2.8).

. . . reduced cost pressures

Sharply lower inflation, the commitment to price stability, and the supporting programs of public sector wage restraint all appear to have been significant in slowing wage settlements in major collective agreements. Public-sector settlements fell from their peak of 6.4 per cent at the start of 1991 to below 3 per cent by the second half of the year (Chart 2.9). The programs have also reinforced the decline in private-sector settlements and accelerated their adjustment to labour market conditions. Private-sector settlements have declined from a peak of 6.4 per cent in the third quarter of 1990 to 3.3 per cent by the fourth quarter of 1991.

. . . delivers lower interest rates

The easing in inflation pressures through 1991 allowed substantial declines in interest rates. Short-term rates (the 90-day commercial paper rate) have declined by about 250 basis points since the February budget, and about 650 basis points since their peak in May 1990. The 90-day paper rate is now at its lowest level since 1978, except for a very brief period in early 1987. The chartered bank prime lending rate is at its lowest in almost 19 years. The one-year mortgage rate is at its lowest since one-year mortgages were introduced in the mid-1970s (Chart 2.10).

The differential between Canadian and American short-term interest rates has narrowed from 565 basis points at the peak in May 1990 to less than 350 basis points. With inflation now lower in Canada than in the United States, the opportunity for further easing in Canada relative to U.S. rates is enhanced to the extent inflation progress is maintained.

Interest rates for mortgages and prime lending affect households and businesses more directly than money market rates. Here, for example, prime lending rates in Canada are only 100 basis points above the U.S. prime, reflecting in part the sound capital position of Canadian financial institutions.

Rates in the major European economies, with the exception of the United Kingdom, moved up in 1991. Japanese rates rose through the first half of 1991 but have since fallen significantly. As a result, Canada now has the third lowest short-term interest rates in the G-7 in both nominal and real terms (Chart 2.11).

A decline in longer-term interest rates in Canada shows the improvement in inflation expectations. Since the February 1991 budget, the 10-year government bond rate is down over 100 basis points. Again, the decline in longer-term rates in Canada was greater than in the United States. By the end of 1991, the differential between long-term government bonds in Canada and the United States had narrowed to about 110 basis points from over 170 basis points at the time of the February 1991 budget.

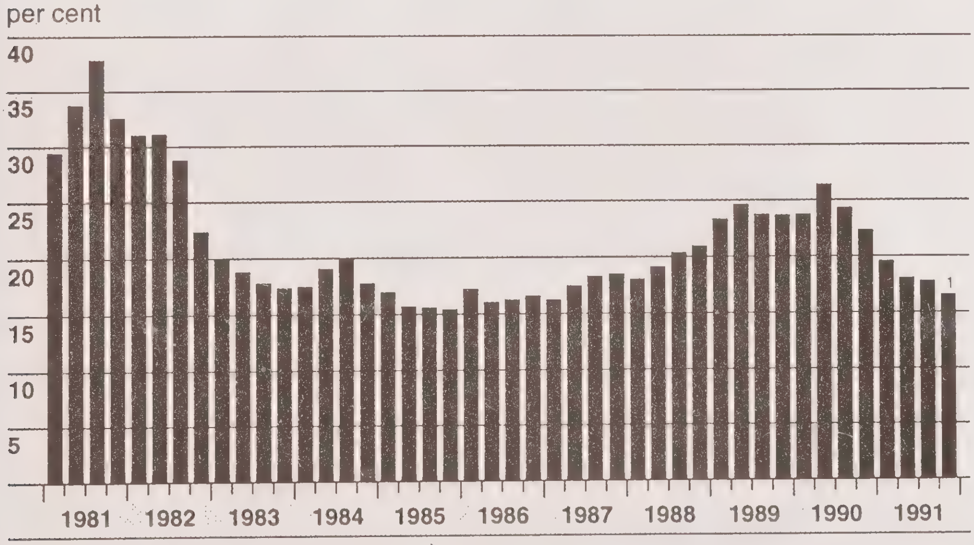
These lower interest rates provide a powerful stimulus to domestic demand by lowering the cost of major purchases to households and businesses and by reducing the cost of servicing existing debt. For example, declines in mortgage rates have produced sharp improvements in housing affordability, reaching levels last seen in 1987 (Chart 2.12). Relative to their peak levels of May 1990, lower mortgage rates have reduced typical

monthly payments on a $75,000 mortgage amortized over 25 years by $309 with a one-year term and $236 with a five-year term (Chart 2.13).

Lower rates also apply to the stock of consumer debt, producing further reductions in debt service costs. Taken together, these savings translate into a significant source of disposable income for Canadian families: based on available data through last September, total savings on mortgage and other interest payments made by Canadian families had already reached $1.5 billion as a result of interest rate declines. These savings will mount as more households renew their mortgages and other consumer debt at much lower rates. Savings are also accruing to firms that renew corporate debt at lower rates. For example, the monthly payment on a $200,000 small business loan amortized over 10 years has fallen by $856, or almost 25 per cent, since May 1990. Lower debt service costs in both the household and business sectors are providing funds that will be spent as confidence rebounds.

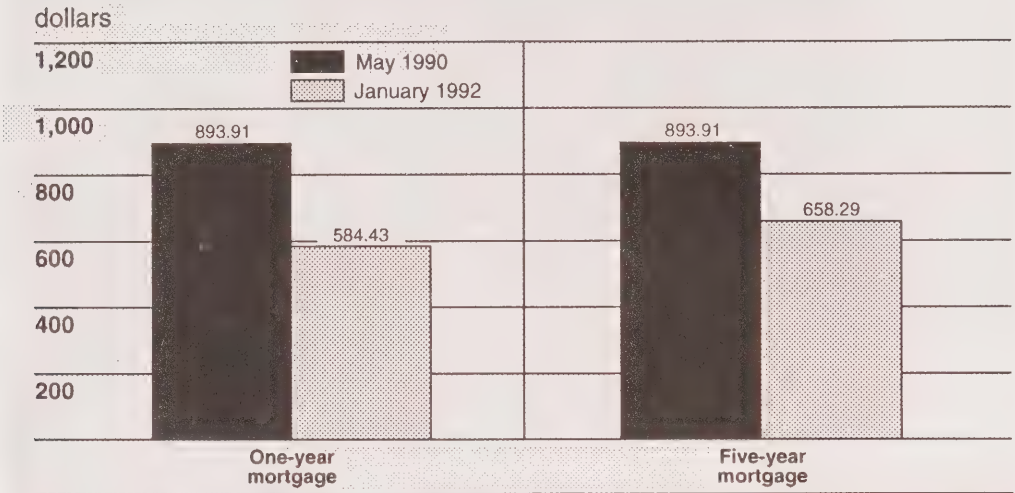
In addition to lower costs of debt issuance and debt service, the Canadian corporate sector is also enjoying a lower cost of equity capital because of the recent rise in stock markets. This rise not only reflects renewed investor optimism, but also encourages business to undertake new investment by reducing the costs of financing such projects.

Chart 2.12
Housing affordability
Monthly payments as a share of disposable income



[1] Fourth quarter value is an estimate.

Chart 2.13
Impact of lower mortgage rates on typical monthly payments[1]



[1] Based on $75,000 principal amortized over 25 years. 1990 calculations are based on typical one-year and five-year mortgage rates of 14 1/4 per cent.
The 1992 calculation is based on rates of 8 1/4 and 9 3/4 per cent respectively.

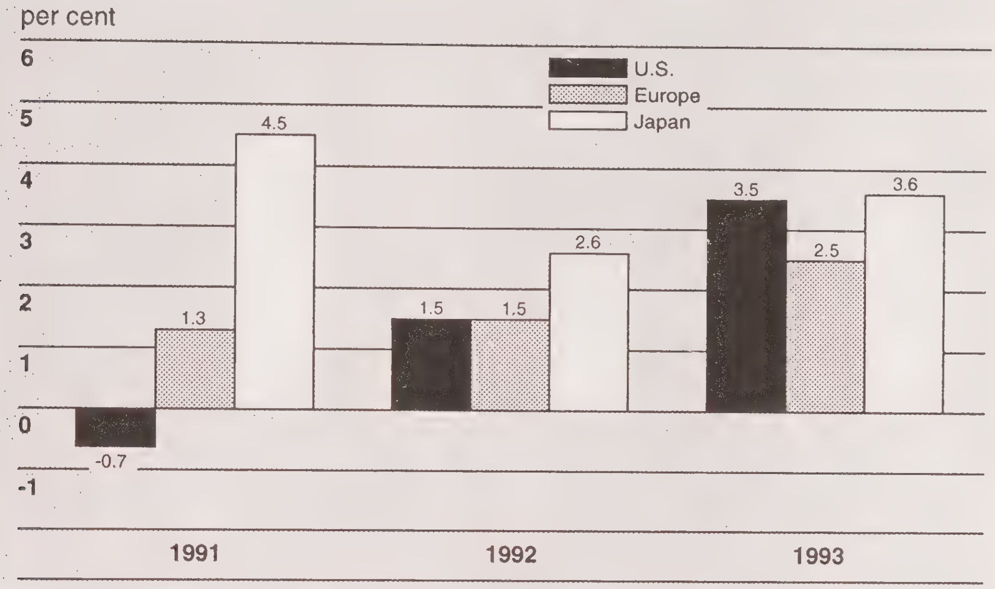
Short-term economic prospects, 1992 and 1993

In turning to the detailed Canadian outlook for 1992 and 1993, we first consider the international economic context for that period. Growth in the U.S. economy is particularly important in assessing Canada's growth prospects but this should not obscure the key advantages that the Canadian economy has developed relative to the U.S. economy. As the Annexes to this Chapter and to Chapter 3 demonstrate, Canada's growth prospects are enhanced by a better fiscal situation at the national level, a household sector that is on a sounder financial footing and lower inflation rates than those forecast for the United States. These structural advantages help to underpin the stronger economic performance that Canada is expected to achieve relative to its major trading partner over both the short term and the medium term.

Prospects for the United States and major overseas economies

After a recession that was mild by historical standards, the U.S. economy surprised almost all analysts last fall when it fell back from the modest pace of recovery experienced in the second and third quarters, remaining essentially flat in the fourth quarter. However, confidence will rebound in response to substantial declines in interest rates. The Federal Reserve Board has eased monetary conditions significantly; since the end of 1990, the 90-day commercial paper rate has declined 400 basis points to the lowest level in 20 years, culminating in sharper cuts in rates in the fourth quarter of 1991 in the face of the weakening economy. Since monetary stimulus normally requires up to 18 months to achieve its fullest impact on economic activity, past easing will be a powerful cumulative stimulus to growth throughout 1992.

Chart 2.14
Real GDP/GNP growth in the United States and overseas economies



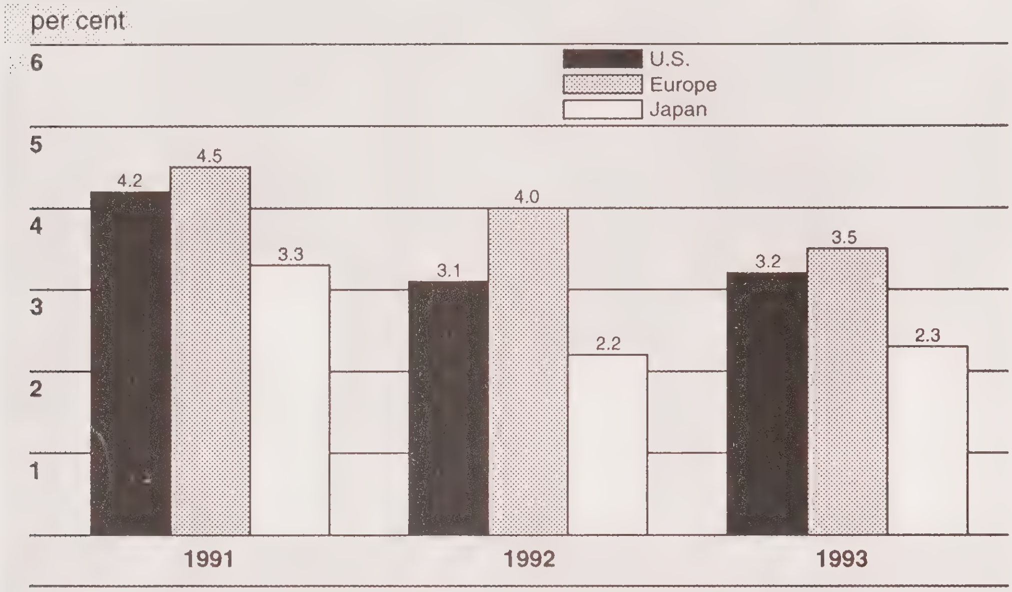
Although U.S. growth in the first quarter of 1992 will be sluggish, the economy is projected to pick up steadily over the remainder of the year, output rising at a fairly robust annual pace of over 3½ per cent during the last half of 1992 and the first half of 1993. Even so, real GDP for the whole of 1992 is expected to show a rise of only 1.5 per cent, following a decline of 0.7 per cent in 1991 (Chart 2.14).

Residential and business fixed investment and inventory re-stocking are expected to be the main contributors to the U.S. recovery. Exports are expected to show continued strength, reflecting both improved competitiveness and an economic pickup among U.S. trading partners. Imports, however, are expected to rise as the U.S. domestic economy rebounds, making net exports a mild drag on the economy. The recovery will remain below cyclical norms for a number of reasons, including still-burdensome household and corporate debt, large layoffs resulting from restructuring in the service sector and an overhang of commercial real estate.

Inflation is projected to continue the moderating trend of the past year because of slack labour markets and excess production capacity. The CPI inflation rate is projected to fall from 5.4 per cent in 1990 and 4.2 per cent in 1991 to 3.1 per cent this year (Chart 2.15). Low inflation will reinforce purchasing power, confidence and spending. By reducing inflationary expectations, it will also encourage further declines in long-term interest rates, which are key to stimulating business investment.

In spite of the limits on federal discretionary spending imposed by the *Budget Enforcement Act* of 1990, the federal deficit is expected to rise significantly in fiscal 1992 from a record high of $269 billion in fiscal 1991. Although the precise outcome will be dependent on the extent to which the Administration and Congress can agree on the President's budget proposals, this year's deficit is expected to rise to about $400 billion.

Chart 2.15
CPI inflation in the United States and overseas economies



Relative to the size of the economy, the Administration expects the deficit to rise from 4.8 per cent of GDP in fiscal 1991 to 6.8 per cent in fiscal 1992, before dropping to 5.7 per cent in fiscal 1993. The increase in the deficit in 1992 results from both the continued effect of the economic downturn on tax receipts and a further increase in deposit insurance payments and in payments made by the Resolution Trust Corporation. Indeed, real spending on goods and services at the federal level is expected to contract over the near term.

Growth in major overseas countries is projected to be mixed in 1992, continuing a pattern that became evident in 1990. Countries that slowed sharply or slipped into recession in 1990 and early 1991 – the United Kingdom, France and Italy – are expected to pick up this year. In contrast, Japan and western Germany are forecast to slow significantly, on an annual average basis, after several years of strong growth. In 1993, most major European countries are expected to approach their growth potential and growth in Japan and western Germany is expected to rebound as well. Inflation is expected to decline moderately in most overseas G-7 countries in 1992 and early 1993, owing to significant output and labour market gaps and subdued commodity price increases. In Germany, however, faster unit labour cost growth and increases in various administrative and indirect taxes are forecast to keep inflation high in the near term and thereby restrain the room for European monetary easing.

Table 2.1
Short-term international economic prospects

	1991	1992	1993
	(per cent change unless otherwise specified)		
United States			
Real GDP	-0.7	1.5	3.5
CPI Inflation	4.2	3.1	3.2
Unemployment rate			
(per cent level)	6.8	7.0	6.6
Current account balance			
(billions of dollars)	-7.4	-35.5	-56.1
(share of GDP)	-0.1	-0.6	-0.9
90-day commercial paper rate			
(per cent level, true yield)	6.0	4.3	6.0
(per cent level, real)	1.8	1.2	2.8
AAA corporate bond rate			
(per cent level)	8.7	8.3	8.7
(per cent level, real)	4.5	5.2	5.5
Other major OECD countries			
Real GNP/GDP			
Europe	1.3	1.5	2.5
western Germany[1]	3.2	1.2	2.2
France, United Kingdom and Italy	0.3	1.6	2.7
Japan	4.5	2.6	3.6
Inflation			
Europe	4.5	4.0	3.5
western Germany[1]	3.5	3.5	2.8
France, United Kingdom, and Italy	5.0	4.2	3.8
Japan	3.3	2.2	2.3

[1] Projections for western Germany refer to the pre-unification Federal Republic of Germany.

Canada's short-term economic outlook

Growth to strengthen through 1992 and in 1993

Available evidence suggests continued weakness in the first quarter of 1992. By spring, however, a pickup in growth abroad will be reinforced by improving domestic conditions – profit margins continue to rise, lower interest rates progressively increase household and corporate cash flow as debt restructuring proceeds and a low and stable inflation environment prevails. Together with the impact of the measures contained in this budget, these factors will foster increasing and more balanced growth through the remainder of 1992 and in 1993. Annual average growth in 1992 will remain modest at 2.7 per cent, because of weak growth in the second half of 1991 and early 1992. Annual average growth will be higher by 1993, at 4.5 per cent, reflecting the faster quarterly growth in the second half of 1992 and through 1993 (Chart 2.16). Taken together, annual growth this year and next still remains well below the 4.7 per cent average of growth in the 1983 and 1984 recovery period.

Chart 2.16
Growth in real GDP and final domestic demand

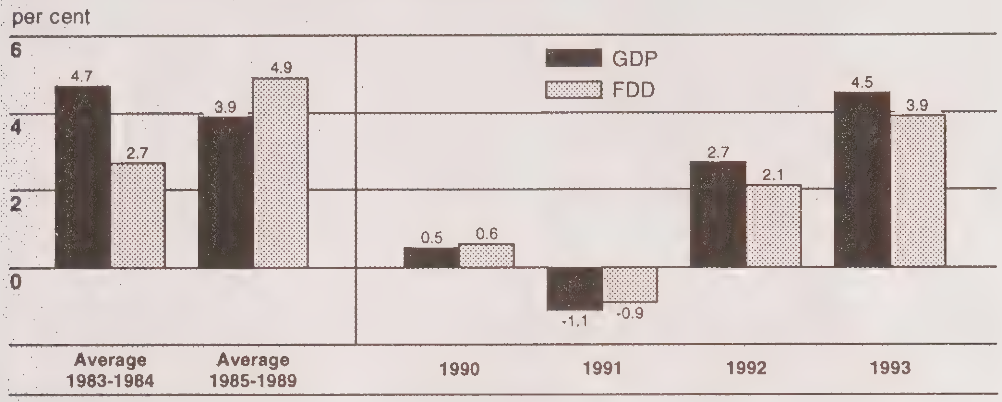


Chart 2.17
Comparison of current recovery with past sustained recoveries: Cumulative growth in real gross domestic product

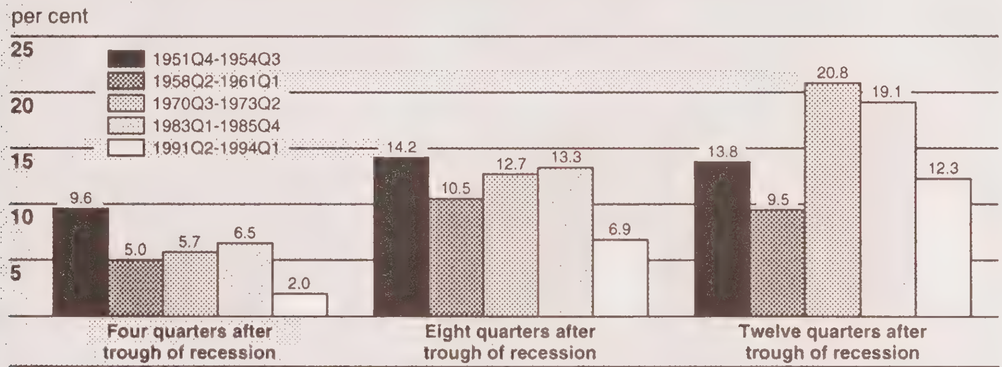
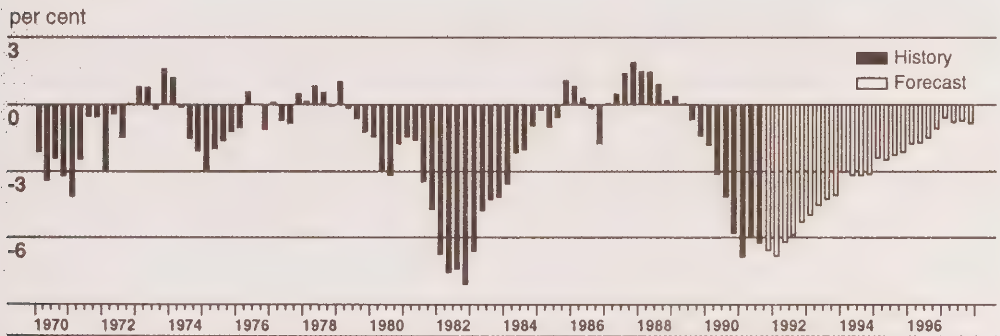


Chart 2.18
Output gap[1]



[1] The "output gap" measures the percentage difference between actual GDP and "potential GDP" where potential GDP is defined as the maximum sustainable (non-inflationary) level of output that can be produced by the economy's existing stock of labour and capital using existing technologies.

Easing inflation pressures will allow further interest rate declines this year and again in 1993. Short-term interest rates are forecast to average 6.9 per cent in 1992, down from 8.9 per cent in 1991, and should ease further to 6.5 per cent on average in 1993.

Fostered by large cumulative interest-rate declines, residential investment and consumer spending are expected to be the main sources of growth in 1992. The effect of lower interest rates on spending builds up gradually, typically requiring up to 18 months to achieve its peak effect. This lag is explained by a number of factors, including the time required for debt restructuring and the time required for decisions on major purchases. In addition, stronger U.S. demand, the recent decline in the dollar, firming commodity prices, enhanced competitiveness, and improved investment conditions will fuel the expansion later in 1992 and in 1993.

Annual growth of 4.5 per cent in 1993 is below the norm of past recoveries. Chart 2.17 depicts the range of growth achieved over the four sustained recoveries since 1951. The present recovery has been weak by historical standards. Excess capacity will thus remain in the economy throughout this period (Chart 2.18), despite the anticipated pick-up in growth in 1993.

Consolidating a better inflation performance

The continuing gap in product markets and the corresponding gap in the labour market will combine with the firm anti-inflation policies of the government to further ease inflation pressures and help consolidate gains already made (Chart 2.19). Moderating wage pressures, combined with a rise in productivity resulting from both cyclical factors and the restructuring evident in a number of industries, will lead to a marked decline in growth of unit labour costs in the near term (Chart 2.20). Year-over-year growth in unit labour costs is expected to decline from 3.6 per cent in the fourth quarter of 1991 to 1.9 per cent in the fourth quarter of this year and to 1.8 per cent in the fourth quarter of 1993, well below the 4.5 per cent average growth in unit labour costs over the period 1985 to 1990.

Slower growth of unit labour costs is crucial to rebuild profit margins from record low levels without jeopardizing the low inflation rates achieved in 1991. The recent easing of the exchange rate will also aid the recovery in profits. Corporate profits before taxes are expected to rise by about 40 per cent by the end of 1992 and again in 1993. However, this profit growth represents a rebound from very low levels and profit margins in 1992 and 1993 will remain well below the levels of the 1983-1989 period.

Steadily bringing underlying cost pressures into line with inflation adds credibility to the commitment of the government and the Bank of Canada to achieving and maintaining price stability. Such progress should permit further easing in monetary conditions this year and again in 1993.

Chart 2.19
CPI inflation

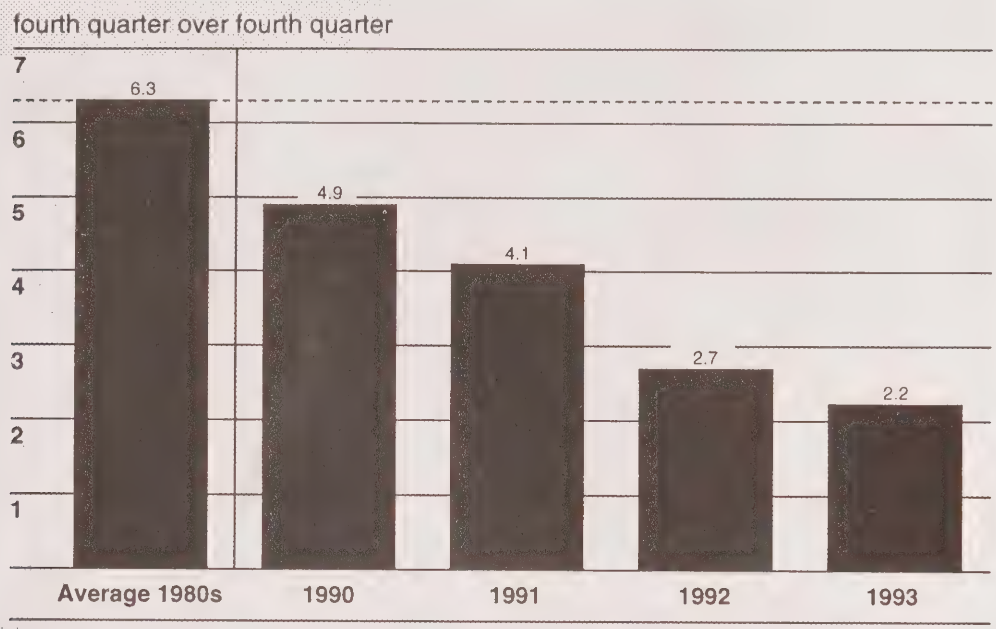
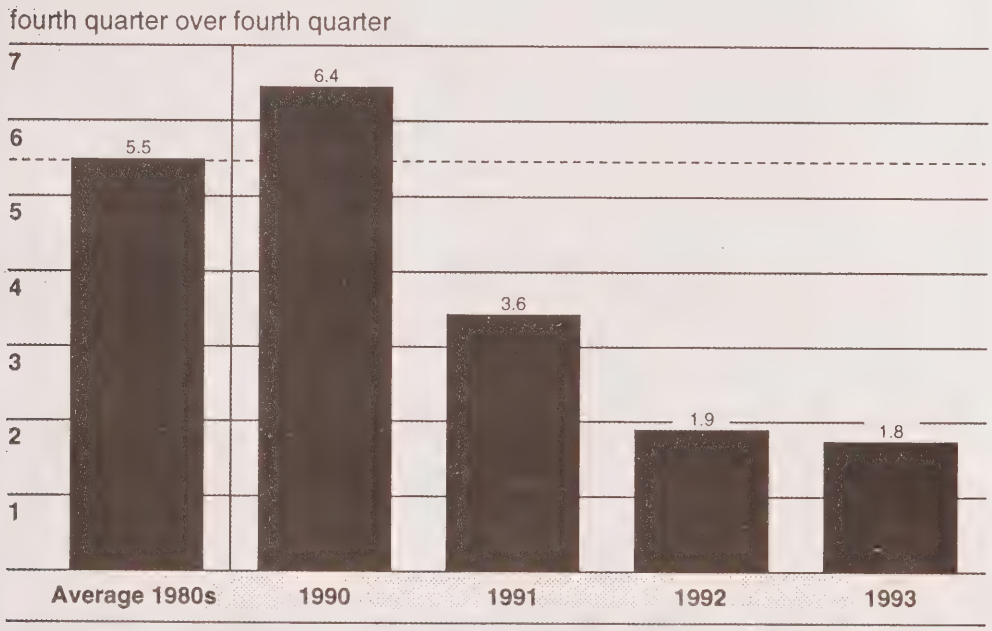


Chart 2.20
Unit labour cost growth



Household spending to continue leading the recovery

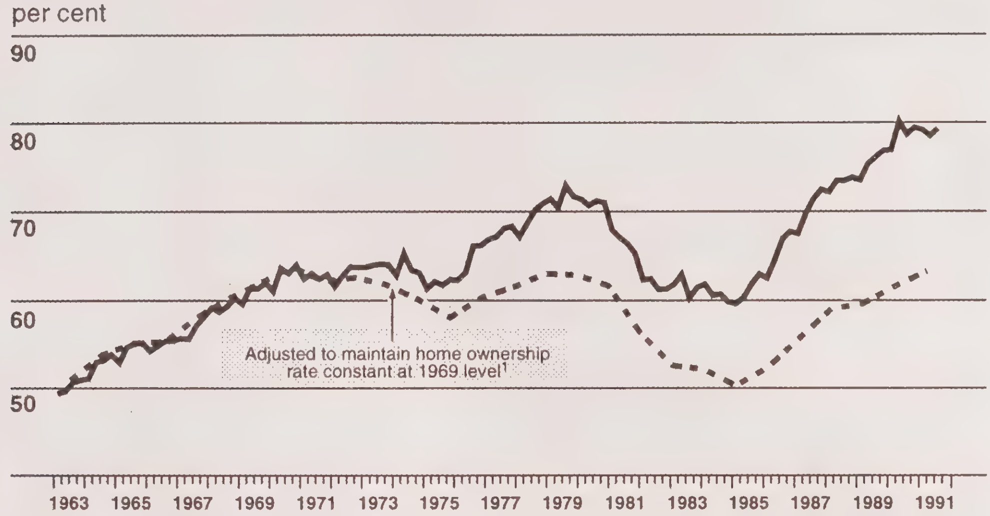
The dramatic drop in interest rates since May 1990 will continue to give strong impetus to growth in the interest-sensitive components of domestic demand, particularly consumer durables and residential construction. Further gradual gains in housing affordability will continue to provide a boost to housing starts as will the delayed effect of the already substantial improvements in affordability. The housing market will be assisted by the reduction to a 5 per cent minimum down payment on CMHC-approved mortgages for first-time home buyers and by the proposed use of RRSP funds for down payments. Residential investment will also rise through the near term with the growing realization that low inflation and low interest rates are here to stay. Moreover, significant pent-up demand for housing exists after nearly two years of starts below demographic requirements. Housing starts are forecast to meet new demographic requirements, which exceed 200,000 units at an annual rate, by next year although a backlog of unfilled needs will remain through 1993.

Total consumer spending is expected to rise at an average annual rate of 2.1 per cent in 1992, picking up to 3.8 per cent growth in 1993. Personal disposable income will rise as a result of the tax and transfer measures proposed in this budget. In addition, growth in consumption will outstrip the rise in real disposable income in 1992 and 1993 as the savings rate drops in response to rising consumer confidence instilled by lower inflation and low interest rates. Financial positions of households will not provide the boost to economic growth that they did in 1983-1984, since debt burdens have not been pared to the extent that they were in the last recession. Nevertheless, household debt will not be a major constraint on spending over the forecast period. The importance of this household sector debt buildup can be easily exaggerated by using aggregate data. Chart 2.21 shows that the trend increase in personal debt during the 1970s and 1980s was almost entirely accounted for by the increase in mortgage debt due to the rising rate of home ownership as the baby-boom generation aged. This mortgage debt was matched by appreciating asset values, leaving the net asset position of the household sector improved.

The contribution of non-residential investment to growth will be modest this year. Excess supply of office space will lead to a further decline in investment in non-residential construction in the first part of the year. Machinery and equipment investment, on the other hand, will grow by 1.8 per cent in 1992. The faster write-off proposed for investment in manufacturing and processing machinery and equipment will help to underpin the rebound in machinery and equipment investment this year. Growth in real investment spending will strengthen in 1993, averaging 8.5 per cent for machinery and equipment and 2.9 per cent for non-residential construction. Business investment will be aided by a recovery in profit margins, lower corporate income tax rates in the manufacturing and processing sectors, correspondingly stronger business confidence, a much lower cost of capital, and rising utilization rates. The cost of capital is falling for three reasons. First, much lower real interest rates mean that the real cost of funds for business investment in 1993 will be only slightly more than one-half its 1990 level. Second, lower inflation also reduces the real cost of funds because of the associated reduction in risk and uncertainty. Third, the elimination of the federal sales tax on capital goods has permanently lowered the cost of capital and will encourage business investment to respond more rapidly to the improving fundamentals over the next two years.

Competitiveness gains will spur export growth to 6.2 per cent between the fourth quarter of 1991 and the fourth quarter of 1992, raising it above the moderate pace of gains in economic activity expected in the economies of Canada's major trading partners. Despite import growth broadly in line with domestic demand through 1992, net exports will thus

Chart 2.21
Personal debt as a share of disposable income



[1] Personal debt adjusted such that mortgage debt grows in line with average annual growth in the number of households, holding constant at its 1969 level the proportion of households that own homes.

improve substantially this year. The real trade balance will improve further in 1993 as even lower inflation and higher productivity make Canada more competitive in both export and import markets, and a pickup in the U.S. and overseas economies raises foreign demand for Canadian goods and services.

The combination of strengthening export growth and falling interest rates will improve Canada's external accounts somewhat in 1992 although anticipated further declines in the terms of trade will limit the current account improvement this year. Improvement in Canada's terms of trade and continued progress on the real trade balance will produce a greater shift in the current account through 1993, although the deficit will remain high by historical standards. Relative to the size of the economy, the current account deficit is projected to fall from 4.4 per cent at the end of 1991 to 3.8 per cent at the end of 1992 and 2.4 per cent at the end of 1993. While this forecast progress is substantial, the current account deficit will remain worrisomely large this year and next, demonstrating the critical importance of fiscal consolidation at all levels of government in order to limit further accumulation of foreign debt.

Table 2.2
The Canadian economic outlook: Main economic indicators, 1991 to 1993

	1991	1992	1993
		(per cent change unless otherwise specified)	
Expenditures (volumes)			
Gross domestic product (GDP)	-1.1	2.7	4.5
Consumption	-1.0	2.1	3.8
Residential investment	-8.5	11.9	10.9
Business non-residential Investment	-4.0	0.5	6.4
Machinery and equipment	-2.5	1.8	8.5
Non-residential construction	-6.2	-1.7	2.9
Government expenditure	3.1	0.6	1.1
Final domestic demand	-0.9	2.1	3.9
Inventory change (contribution to growth; per cent)	0.3	0.5	0.3
Exports	0.8	5.6	6.5
Imports	1.3	5.6	5.4
Net exports change (contribution to growth; per cent)	-0.2	-0.1	0.3
Current account balance			
(billions of current dollars)	-25.7	-30.8	-22.6
(per cent of GDP)	3.8	4.3	2.9
Housing starts			
(thousands of units)	152	180	222
Prices and costs			
Annual average			
Consumer price index (CPI)	5.6	2.2	2.2
CPI excluding food and energy	5.8	2.8	2.3
GDP deflator	2.9	1.7	3.1
Labour income per employee	5.8	4.0	3.2
Unit labour costs	5.0	2.4	1.7
Fourth over fourth			
CPI	4.1	2.7	2.2
CPI excluding food and energy	5.1	3.0	2.2
Labour market			
Labour force	0.6	1.1	2.3
Employment	-1.8	1.1	3.0
Unemployment rate (per cent, fourth quarter level)	10.3	10.1	9.5
Incomes			
Real personal disposable income	-0.5	0.9	3.4
Corporate profits	-28.5	32.8	36.9
Personal savings rate (per cent)	10.9	10.1	9.9
Financial market (per cent)			
90-day commercial paper rate			
Nominal	8.9	6.9	6.5
Real[1]	3.3	4.7	4.3
Long-term government bond rate			
Nominal	9.8	8.5	8.3
Real[1]	4.2	6.3	6.1

[1] Real interest rates are defined as the nominal rates minus the percentage change in the consumer price index.

Chart 2.22
Employment and labour productivity growth

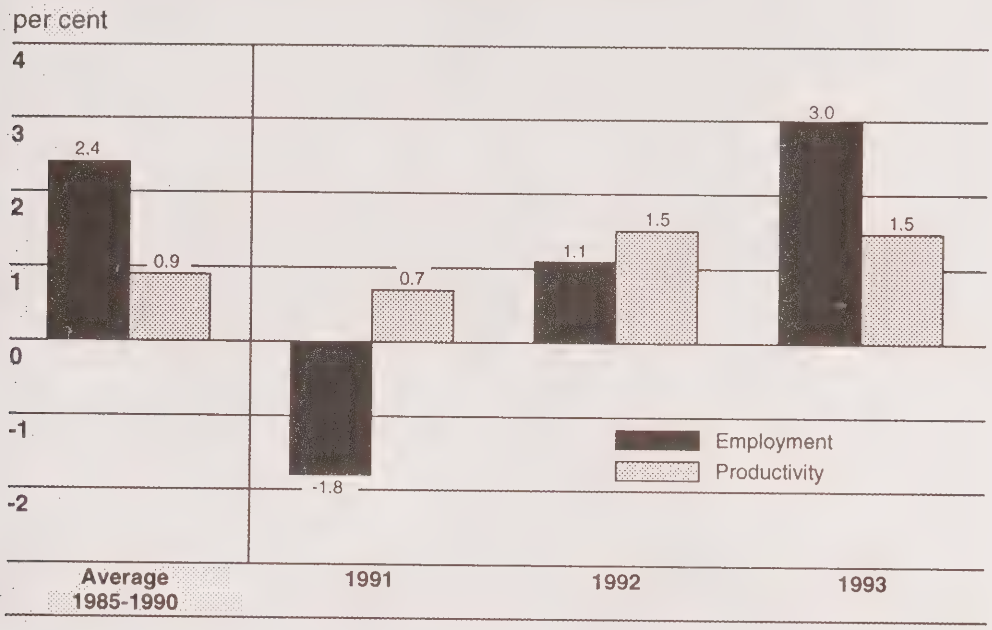
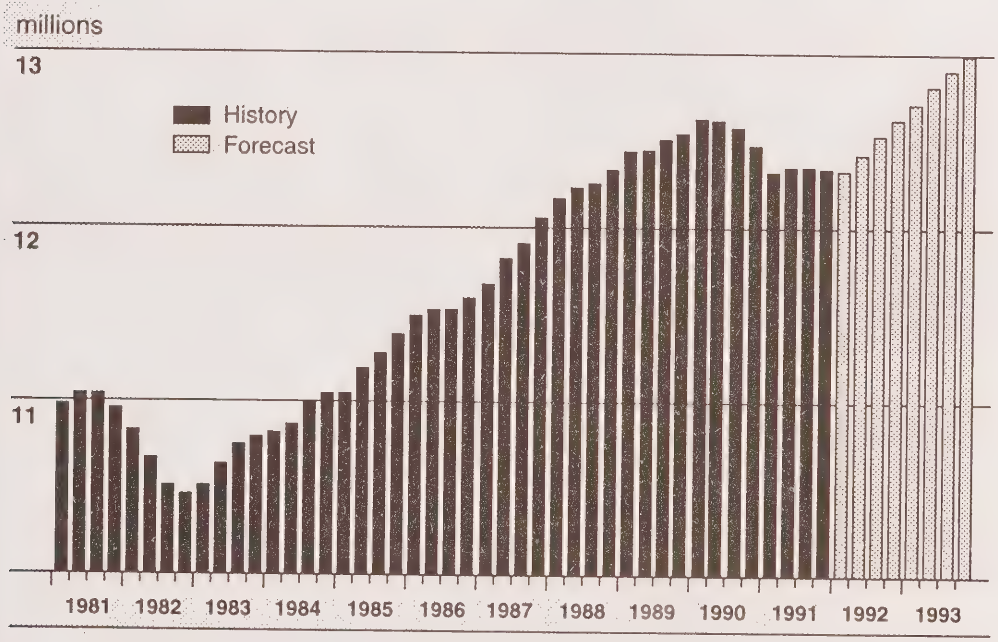


Chart 2.23
Total employment



Employment will grow steadily through 1993

Several industries are restructuring because of structural reforms in recent years and growing globalization of economic activity. Businesses are modernizing plant and equipment, downsizing operations in some cases, expanding in others, and almost always reducing overhead costs. In the short run, restructuring in a period of slow economic activity reduces labour demand. Over time, however, labour productivity will rise as economic activity picks up, increasing competitiveness and creating more jobs. This effect will be evident next year, when growth in both labour productivity and employment will rise above average rates in the 1985-1990 period (Chart 2.22). As a result, employment creation in the range of 300,000 jobs per year should be achieved in 1992 and 1993 (Chart 2.23).

The decline in the unemployment rate will be restrained over the next two years by strong growth in the labour force, due mainly to re-entry of individuals who had previously stopped looking for work. The unemployment rate will thus decline only modestly over the near term, averaging 10.3 per cent in 1992 and 9.7 per cent in 1993.

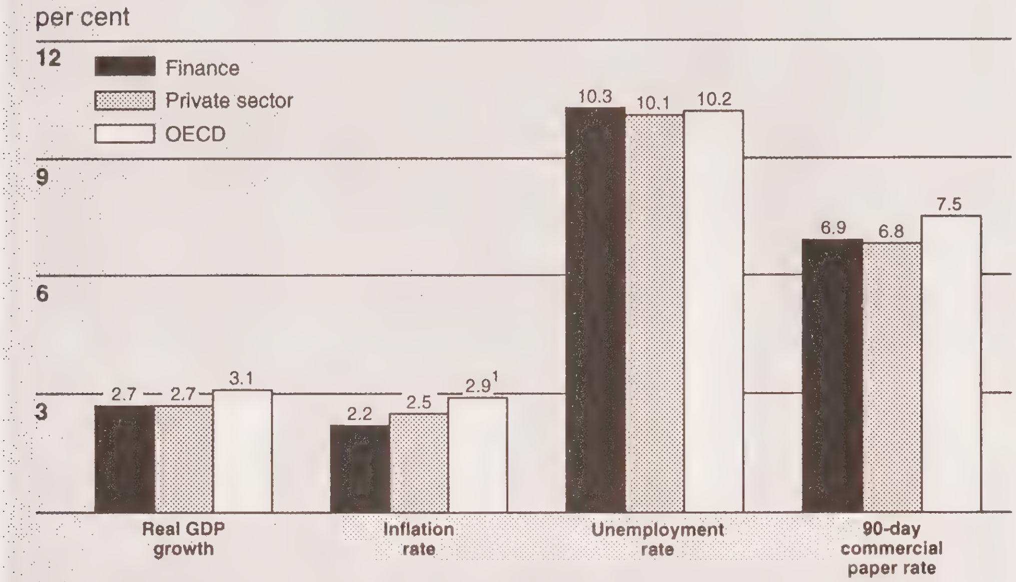
Comparison with other forecasts

(i) Private sector

Private-sector forecasters have substantially lowered their forecast for growth in 1992 from 3.5 per cent in October to 2.7 per cent. Charts 2.24 and 2.25 compare the short-term economic forecast described in this budget with the average of 20 private-sector forecasts as reported in a survey carried out in January by the Department of Finance.

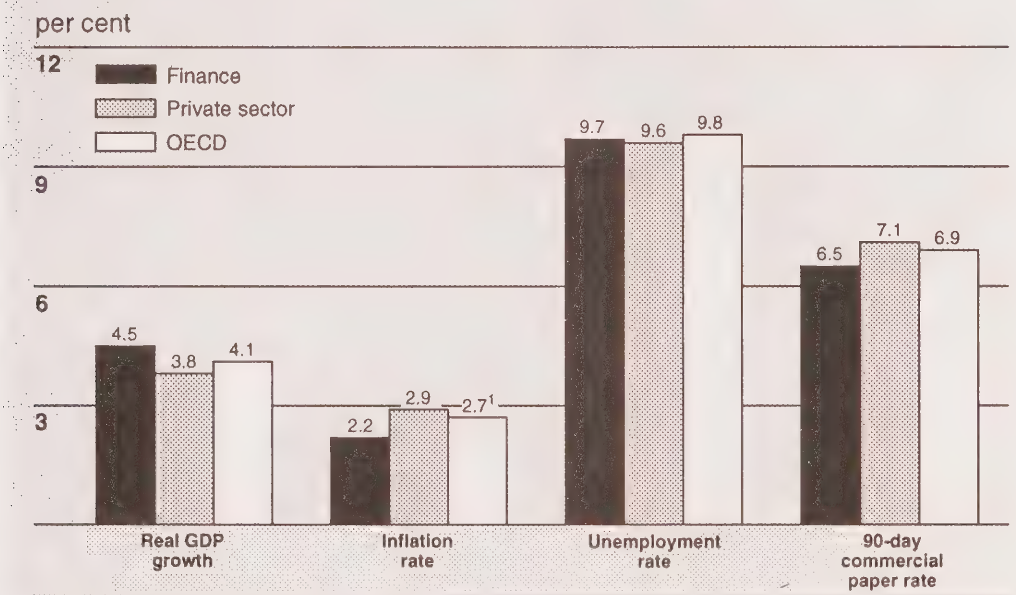
- The consensus sees the recovery continuing through the near term, but at a moderate pace by historical standards. Its projection of real GDP growth of 2.7 per cent in 1992 equals the Finance Department forecast. The consensus expectation of growth at 3.8 per cent in 1993 is less than the Finance forecast of a strengthening to 4.5 per cent.
- The private-sector consensus is slightly more optimistic than the Finance forecast for labour market conditions, expecting the unemployment rate to average 10.1 per cent this year and 9.6 per cent in 1993.
- The consensus forecast for inflation is somewhat higher than Finance's but the private-sector forecasters agree that inflation will remain near the targets for 1992 and 1993.
- Both the private-sector consensus and Finance project a significant decline in interest rates in 1992. In 1993, however, the consensus forecasts a slight rebound, reflecting a view that a pickup in output growth will raise inflation pressures and thus interest rates as well, whereas Finance projects a further decline in interest rates consistent with the sustained progress on inflation that will result from persistent output and labour market gaps.

Chart 2.24
Comparison with other forecasts for 1992



[1] Consumption deflator.

Chart 2.25
Comparison with other forecasts for 1993



[1] Consumption deflator.

(ii) The OECD

The OECD lowered its forecast for output growth in the G-7 in 1992 from 3 per cent in October to 2.2 per cent in December. Nonetheless, the OECD's December forecast for Canada is similar to Finance's view that the recovery will be moderate in 1992 and that growth will pick up strongly in 1993. The OECD expects real GDP growth to average 3.1 per cent in 1992 and 4.1 per cent in 1993 (Charts 2.24 and 2.25). The OECD's inflation outlook is consistent with the government and Bank of Canada's inflation targets.

Overall, the OECD forecasts that Canada will lead all G-7 countries in economic growth both this year and next, while maintaining an improving inflation performance.

CANADA'S MEDIUM-TERM ECONOMIC PROSPECTS, 1994-1997

Any medium-term economic outlook must by its very nature be a projection of economic outcomes dependent on a wide range of assumptions regarding economic policies, international developments and non-economic factors. In this sense, the longer the time horizon in question, the more important for the outlook are the risks associated with the assumptions made about the context within which the economy evolves.

Two important assumptions are worth highlighting here in the context of this medium-term outlook. First, it is assumed that current issues of national unity are successfully resolved in such a way that the Canadian economy remains a strong, cohesive entity. Second, it is assumed that the federal and provincial governments are able to collectively manage their fiscal situations and co-ordinate their policies such that Canada avoids rising total government deficits and public debt over the medium term and the economic dislocation that would ensue.

On the assumption that these issues are resolved satisfactorily, the Canadian economy is poised to reap the payoff from the sound framework of macroeconomic and structural policies established in Canada in recent years. This payoff will come in the very tangible form of a strong medium-term economic performance, producing jobs and prosperity for Canadians in sustainable, non-inflationary ways.

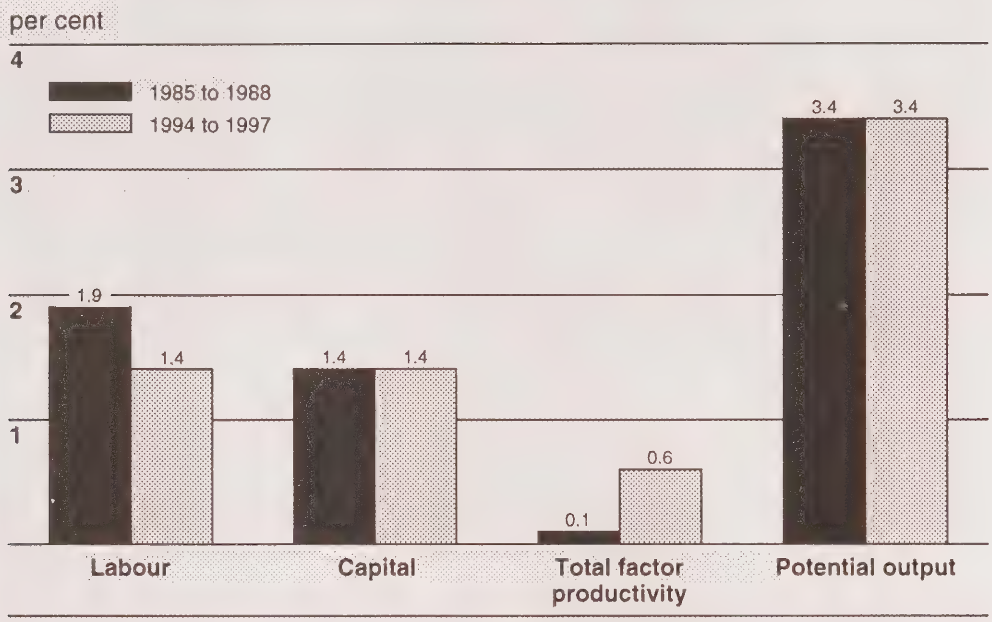
The framework policies will help to reduce and ultimately eliminate the kind of structural imbalances that led to boom-bust cycles in the past. Inflation will cease to keep interest rates too high and distort economic decision making. The government will start to pay off debt, freeing domestic private saving for productive investment. This will substantially reduce excessive reliance on foreign saving, particularly for consumption, and limit the draining of Canadians' rewards for their productive efforts into foreign debt-servicing.

Growth prospects boosted by sound policy

The government's structural and macroeconomic policy initiatives described above will boost the rate of growth in potential output over the medium term. Potential output growth of 3.4 per cent over the 1994-1997 period will match that of the corresponding period in the 1980s expansion despite slower growth of the labour force (Chart 2.26).

Three factors produce potential output growth: growth in the labour force, a growing stock of capital investment, and increasing total factor productivity (the net impact on output of new technologies and new ways of combining workers and capital assets). The policy framework augments all three sources of potential growth.

Chart 2.26
Sources of potential output growth



Although the participation rate will grow more slowly than it did in the corresponding years of expansion in the 1980s, increased immigration levels will add to the growth rate of the labour force.

- Replacement of the outmoded federal sales tax makes new investment more affordable, particularly in the fast-growing service sectors. The opportunities created by the FTA and a more liberalized world trading environment also encourage new investment to take advantage of the scale economies made possible by much larger markets. The capital stock will grow by 4.4 per cent a year over the medium term, up from 3.7 per cent during the 1980s expansion.
- The adjustment already occurring as Canadians respond to the opportunities created by these structural initiatives will pay off significantly over the medium term, boosting total factor productivity growth to 0.6 per cent annually, compared with only 0.1 per cent annually in the 1980s.
- Substantial gains in productivity and investment when inflation stops distorting economic decisions will support further gains in potential output beyond the medium term.

Excess capacity permits above-potential medium-term growth

This forecast takes a cautious approach to projecting medium-term growth, assuming that the excess-supply gap will persist much longer than usual. As Chart 2.18 demonstrates, excess-supply gaps created by Canadian recessions have typically closed rather quickly once recovery got under way. For example, the large output gap that emerged as a result of the 1981-1982 recession was completely absorbed over the first three years of the expansion that followed. The assumption of a persisting gap in this forecast is based both on prudence and the possibility that the restructuring now under way could slow output

growth for a few years before boosting it significantly in the following years. The excess-supply gap that emerged by 1991, approaching 7 per cent of GDP, makes clear that several years of above-potential growth will inevitably result when the recovery gathers steam in 1993 and beyond.

Strong business investment buttressed by a steadily improving trade position will support the robust, non-inflationary growth that will persist over the medium-term. Business investment invariably responds with a lag to recovery, as profits are first rebuilt, but the fundamental determinants of investment point to strong growth during the medium-term. Not only are interest rates down dramatically but continued disinflation past 1993 will add to confidence that they will stay down. Indeed, interest rates should stabilize at levels not seen since the 1960s. Growing confidence that low interest rates can be maintained will give business investment a powerful boost, as will more attractive capital consumption allowances and a lower corporate income tax rate for the manufacturing and processing sector. Moreover, the government's structural policies have created new incentives to business investment that will continue to be felt for several years.

Real interest rates remain high by historical standards in this forecast, although they will reach low levels in nominal terms, with the important benefit of reducing the cost of servicing debts such as mortgages that are repaid with constant payments over time. High real rates reflect, in part, the possibility that strong demand on world capital markets from sources such as Eastern Europe and the former Soviet Union will keep borrowing costs from falling substantially, even though monetary authorities throughout the G-7

Table 2.3
Medium-term economic outlook: Selected economic indicators, 1991 to 1997

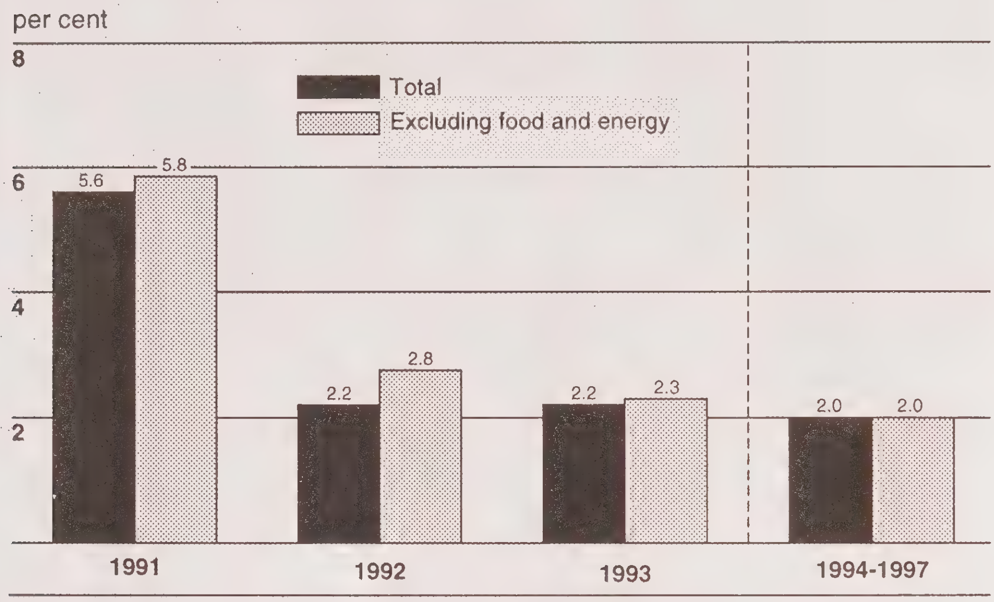
	1991	1992	1993	Average 1994-1997
	(per cent change unless otherwise indicated)			
Real GDP	-1.1	2.7	4.5	4.4
Real exports	0.8	5.6	6.5	4.1
Employment	-1.8	1.1	3.0	2.8
Unemployment rate (per cent, fourth quarter)	10.3	10.1	9.5	7.0[1]
Unit labour costs	5.0	2.4	1.7	1.1
Inflation (CPI)[2]				
Total	4.1	2.7	2.2	1.9
Excluding food and energy	5.1	3.0	2.2	1.9
90-day commercial paper rate (per cent)				
Nominal	8.9	6.9	6.5	6.0
Real[3]	3.3	4.7	4.3	4.0

[1] Annual average for 1997.

[2] Fourth quarter over fourth quarter per cent change.

[3] Nominal rate minus CPI inflation rate.

Chart 2.27
CPI inflation 1991 to 1997



economies take an easier stance. But simple caution also argues for forecasting relatively high real interest rates, because of their key influence not only on the economy but also directly on the fiscal framework through debt service costs. Real interest rates could well be lower than forecast here.

Substantial growth in Canada's exports of goods and services will be underpinned by the gains in cost competitiveness that a continued excellent inflation performance will yield when compared to U.S. inflation that is forecast to remain just over 3 per cent. These gains in competitiveness will provide further incentives to business investment by enabling firms to take advantage of the enormous export markets to which access will be guaranteed by the FTA and international trade liberalization, and of the lower cost of capital made possible by the replacement of the Federal Sales Tax (FST) by the Good and Services Tax (GST).

Strong real output growth over the medium-term means tangible economic benefits for all Canadians. Jobs will be created at a rapid rate, with employment growing by an average of 2.8 per cent a year in the medium term. The unemployment rate will thus fall to about 7 per cent for the first time in 20 years.

Inflation targets to be realized

The series of targets for lower inflation jointly announced in February 1991 by the government and the Bank of Canada aimed at a more rapid and widespread dampening of inflation expectations consistent with the existing goal of achieving price stability. Disinflation has proceeded quite rapidly over the past year, as noted above. Despite output growth exceeding potential for the next several years, the impact on inflation expectations of successful adherence to the targets, plus substantial excess capacity in both output and

labour markets, will ensure continued progress in line with lower inflation targets (Chart 2.27).

Damaging imbalances to be corrected over the medium term

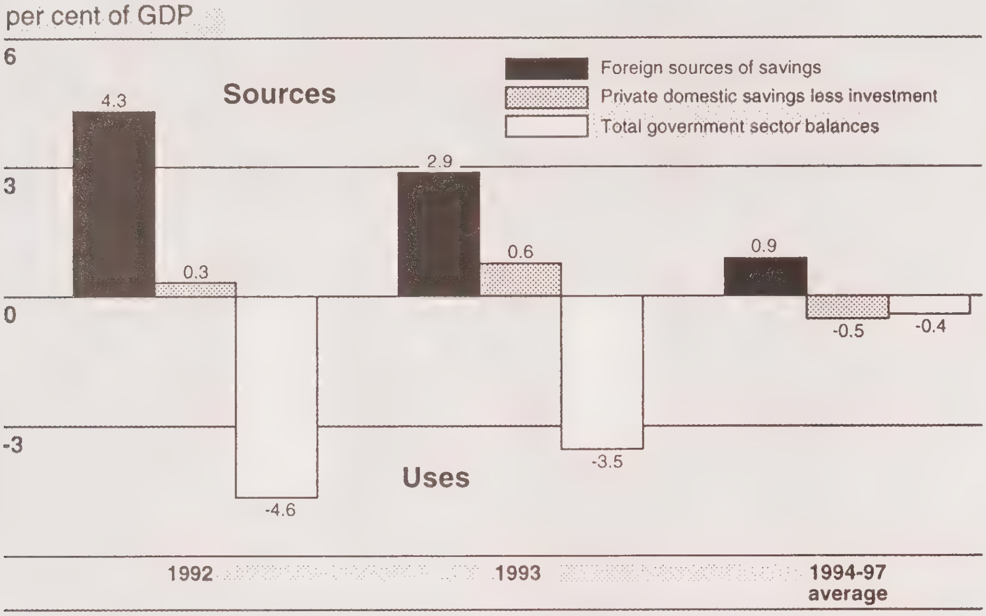
Structural imbalances have plagued Canada's economic performance in recent decades. Entrenched inflation and a persistent fiscal deficit in the public sector that bore little relationship to the cyclical condition of the economy have been the two most fundamental and damaging. These imbalances created significant unused productive capacity at the same time as foreign debt was rising ever more rapidly. Such strains demanded a coherent policy response, without which there was no hope of dealing with all of the imbalances together.

The government's structural and macroeconomic policy agenda has been implemented to respond comprehensively to these problems. The rewards of implementation of this agenda will be abundantly clear in a strong medium-term performance of the Canadian economy. One of the keys to this performance is realizing the government's commitment to fiscal consolidation. By eliminating its significant demand for borrowed funds, the government is opening the way to financing the investment boom Canada needs without recourse to foreign savings. This will stem the growth of foreign indebtedness, allowing Canadians to keep a greater share of the income produced by their own productive efforts (Chart 2.28).

Achieving price stability will add to this mutually reinforcing dynamic by maintaining low interest rates and macroeconomic stability, important preconditions for strong investment and for closing the excess-supply gap. Price stability also boosts our international cost competitiveness, contributing to the improved current account performance that must be the counterpart of reduced inflows on the capital account.

The net result will be a low inflation economy, in better balance both domestically and externally, which will generate higher productivity growth and thus be able to sustain growth in living standards and prosperity. Such an economy will be more flexible than Canada's has been in recent years – able to recover more quickly and smoothly from the inevitable external shocks, such as oil price changes and shifts in foreign growth performance, that have occurred in the past and will again.

Chart 2.28
Sources and uses of savings, 1992 to 1997

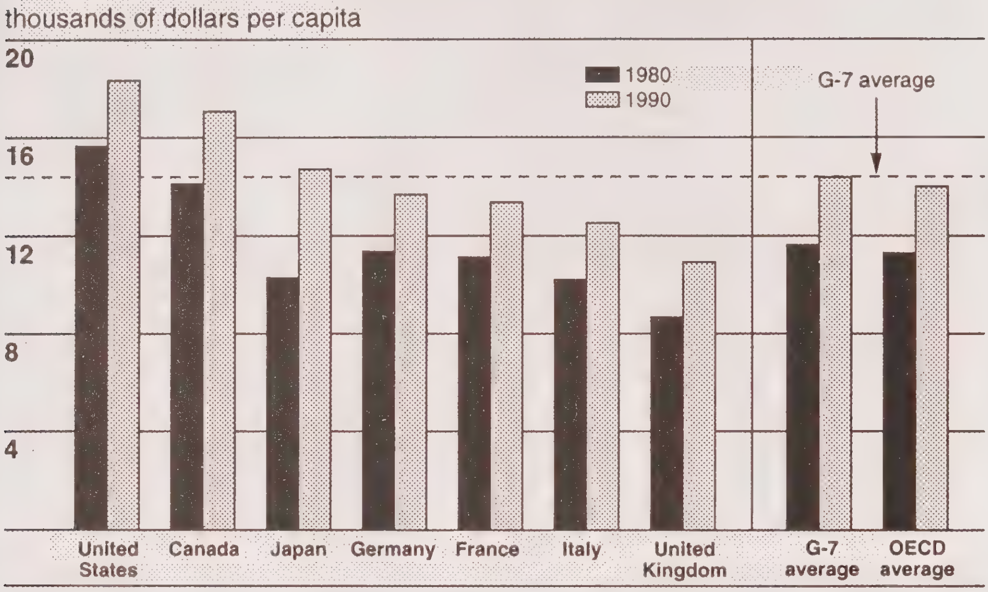


ANNEX
CANADA-UNITED STATES ECONOMIC COMPARISON

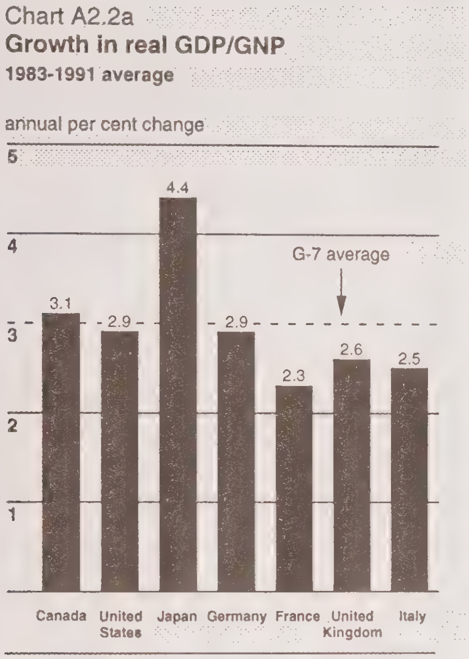
The following key points emerge from the comparison in this Annex of the economic performance of Canada and the United States in recent times:

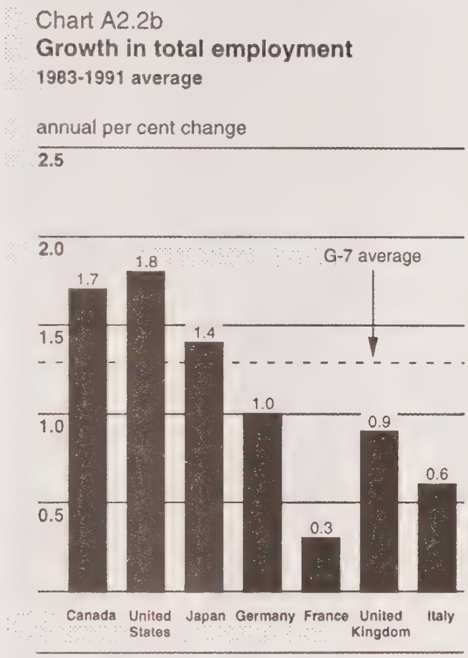
- Canada and the United States were two of the strongest economic performers among G-7 countries over the 1983 to 1991 period in both output growth and job creation. Canada's average rate of GDP growth exceeded that of the United States, while its rate of employment growth was only slightly lower. On both counts, Canadian growth exceeded the OECD average.
- In spite of this strong growth performance, Canada's productivity growth in manufacturing significantly lagged that in the United States between 1985 and 1990. Over the same period, inflation pressures were more intense and labour costs rose more quickly in Canada. As a result, Canada's unit labour costs in manufacturing increased substantially and our competitive position deteriorated relative to the United States.
- Since then, inflation pressures have been sharply reduced and wage pressures have eased. The outlook for inflation is extremely good. The Department of Finance and the OECD project inflation rates of less than 3 per cent in Canada in both 1992 and 1993, compared with 3 to 4 per cent in the United States. Permanently lower inflation carries with it permanently lower interest rates and a lower cost of funds, which stimulate economic growth. Indeed, the OECD agrees that Canada's growth prospects are better than the United States'.
- Canada is well poised to achieve a sustained expansion. Canadian consumers are in a better position to take advantage of lower interest rates than U.S. consumers, whose debt burdens are much larger. The Canadian financial sector is also much sounder overall than its U.S. counterpart and thus in a better position to support growth. Structural reforms have increased the growth potential of the economy and have created new trading opportunities. Most important, our macroeconomic policy, that has succeeded in bringing both inflation and structural fiscal deficits under control, has created the environment essential for the economy to realize its potential.

Chart A2.1
Real GDP/GNP per capita, 1980 and 1990
Constant 1985 U.S. dollars, adjusted for purchasing power parity



- Canada has one of the highest living standards in the world; we rank second among G-7 countries behind the United States, with per capita real GDP equal to about 93 per cent of the U.S. level (up slightly over the last decade).
- Canada's real GDP per capita was nearly 20 per cent higher than the G-7 average in 1990.





- Canada was one of the strongest economic performers among G-7 countries over the 1983-1991 period. Canadian real output expanded at a rate second only to Japan's. During this time, Canada created more than 1.6 million jobs, allowing employment to grow 1.7 per cent a year, similar to the U.S. rate and significantly stronger than that of most other G-7 nations.

Chart A2.3a
CPI inflation

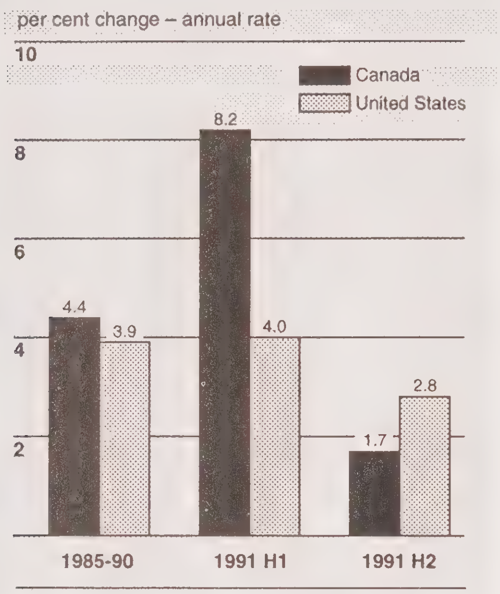
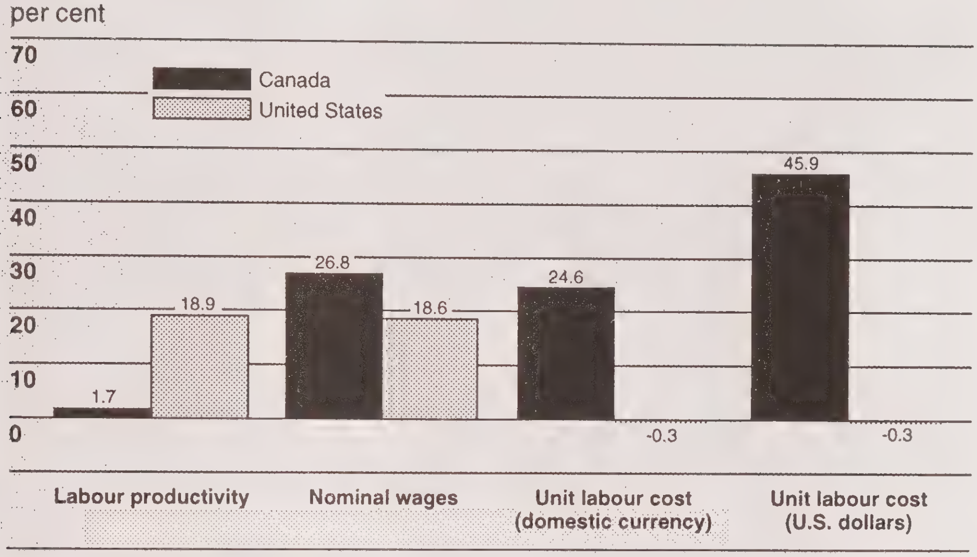


Chart A2.3b
CPI inflation

- In the February 1991 budget, the government set out a series of inflation targets to provide a focal point for policy and to demonstrate to the public the government's commitment to price stability.
- Between 1985 and 1990, inflation was higher on average in Canada than the United States, but in both countries it was too high. Canada has been making remarkable progress in reducing its inflation rate. Although the GST raised the inflation rate in the first half of 1991, the effect was temporary. Inflation in the second half of 1991 fell to 1.7 per cent, more than a full percentage point below the U.S. rate.
- In January of this year, the year-over-year inflation rate fell to 1.6 per cent, the first time it has been below 2 per cent since April 1971.

Chart A2.4
Cumulative growth of manufacturing unit labour cost and its components in Canada and the U.S., 1985-1990



Source: United States Bureau of Labor Statistics.

- High growth of unit labour costs in Canada's manufacturing sector during the second half of the 1980s eroded our competitive position. The U.S. manufacturing sector kept unit labour costs virtually constant during this time.
- Our competitiveness deteriorated because Canadian wages increased at a faster rate than U.S. wages while productivity growth lagged that of the United States. The fact that Canadian unit labour costs rose more when measured in U.S. dollars indicates that the appreciation of our currency also played a role.
- The cumulative rise in Canadian productivity was a meagre 1.7 per cent, compared with 18.9 per cent in the United States.

Chart A2.5a
Ratio of personal debt to disposable income

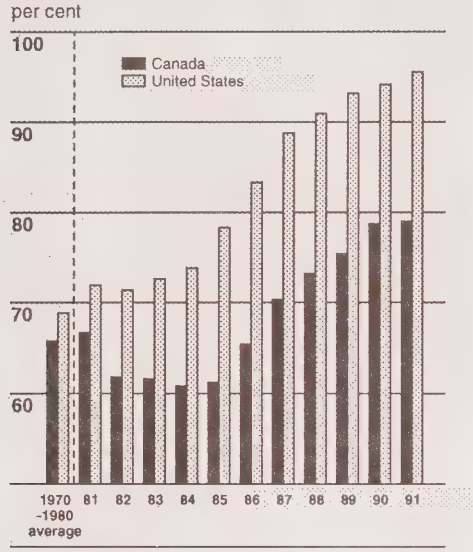
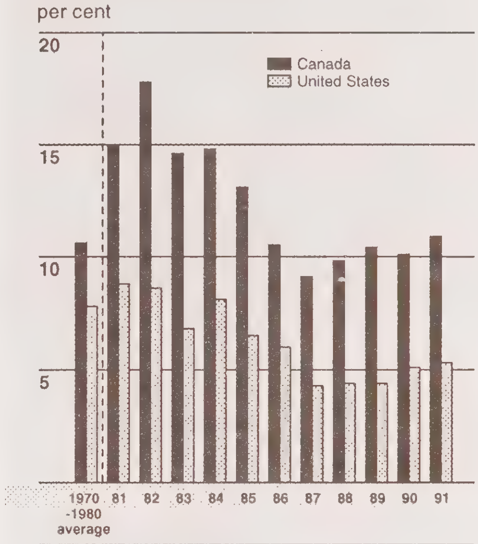


Chart A2.5b
Personal savings rate



- Personal debt burdens rose considerably in both countries over the 1980s, but the increase was much more pronounced in the United States. By 1991, the ratio of U.S. personal debt to disposable income was almost 40 per cent above the 1970-1980 average, while Canada's ratio was only 20 per cent higher than its average.
- The rate of personal savings in Canada is much higher than in the United States. Savings rates in both countries have risen modestly from the cyclical lows in 1987.

Chart A2.6a
Corporate debt-equity ratio manufacturing, mining and trade

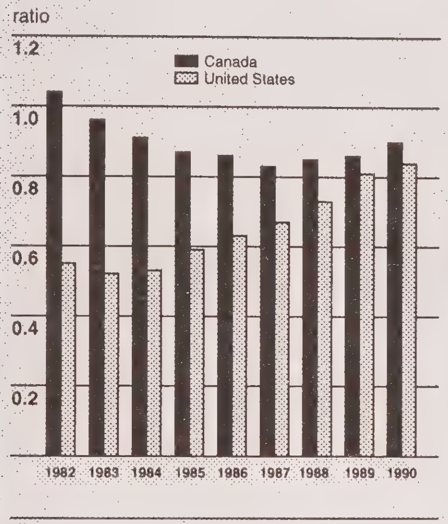
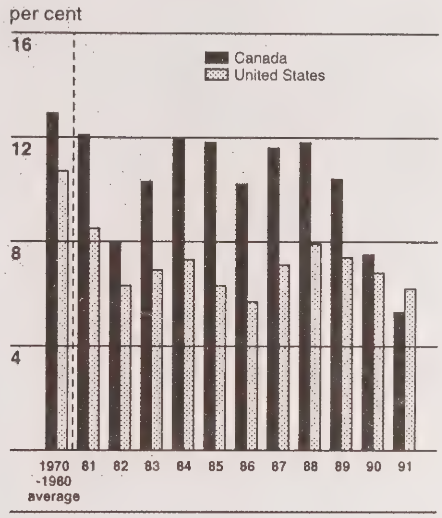
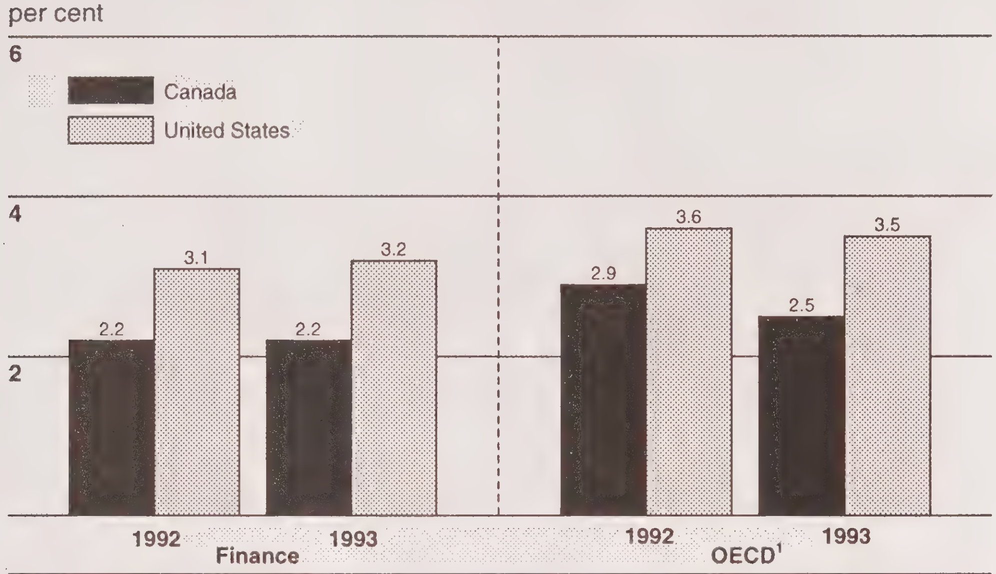


Chart A2.6b
Corporate profit margins economy-wide, National Accounts basis



- Corporate leverage and thus debt burdens are high in both Canada and the United States; the rise in corporate indebtedness has been especially pronounced in the United States.
- Corporate profit margins in both Canada and the United States have experienced a steady cyclical decline since early 1989 and are now near historical lows in both countries. In addition, Canadian profit margins are now comparable to those in the United States after being consistently higher over the past two decades.

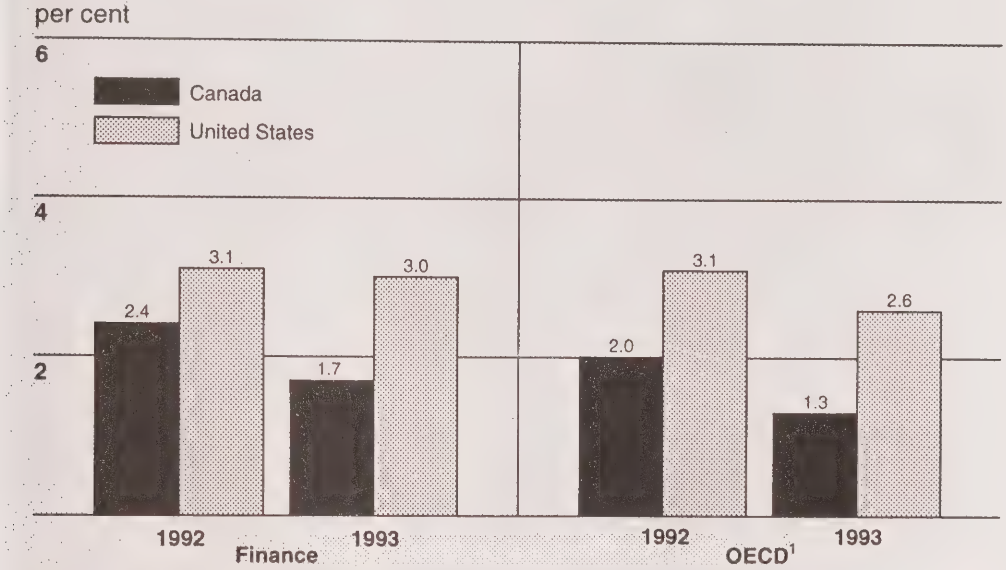
Chart A2.7
Inflation outlook



[1] Private consumption deflator.

- Canada's inflation outlook is extremely good. Our inflation rate is expected to be lower than that of the United States in the near term.
- The Department of Finance and the OECD expect inflation in Canada to remain below 3 per cent in 1992 and 1993, well below expected U.S. inflation rates.
- Permanently low inflation keeps interest rates and the cost of funds low and sets the foundation for sustained economic growth. By achieving and maintaining price stability Canada will be able to eliminate the boom-bust cycles that have been characteristic of our economy.

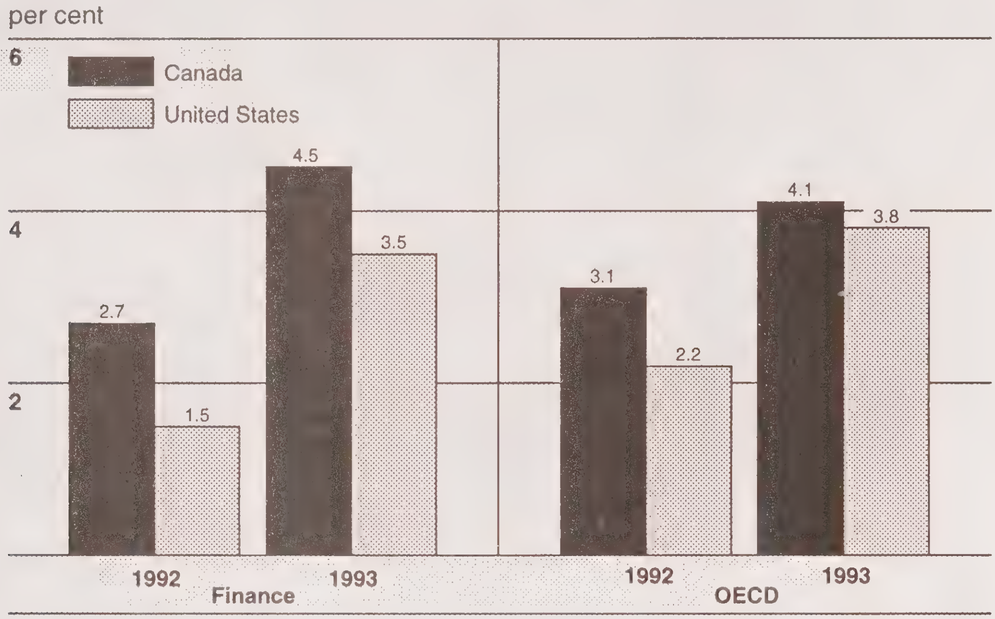
Chart A2.8
Unit labour cost outlook



[1] Unit labour cost growth in the business sector.

- Unit labour costs are expected to grow more slowly in Canada than in the United States in the near term.
- In Canada, declining unit labour cost growth in 1992 and 1993 reflects both strong productivity growth and substantial easing in average wage growth.
- Relative to the United States, the more moderate increases in unit labour costs in Canada are largely associated with higher productivity growth in Canada.

Chart A2.9
Real GDP/GNP growth outlook



- The near-term outlook for real growth is more favourable in Canada than in the United States. The OECD expects real GDP growth in Canada to outpace that in the United States by almost a full percentage point in 1992.
- Strong growth, combined with low inflation and modest wage increases, will allow Canada to raise its productivity growth and so improve its competitive position relative to the United States.

CHAPTER 3: CANADA'S FISCAL SITUATION AND OUTLOOK

OVERVIEW

The policy challenge

Since 1984, the government has been putting in place the foundations for more durable economic performance in an increasingly competitive global market place. The building blocks have included structural reforms, concrete steps in moving toward price stability and fiscal consolidation through expenditure control. At present, the recovery is not as robust or as widely-based as had been expected a year ago. Much of the current weakness reflects the weak international economic situation. As well, confidence is weak, not only in Canada but in other economies. In part, weak confidence relates to the difficulties many countries are facing in adapting to a more competitive world environment; as well, it reflects the need to work through some of the debt-related excesses of the late 1980s.

Short-term fixes don't work; Canada's history has amply demonstrated that they only compromise the future. The challenge is to continue to build the proper environment for sustained medium-term growth. This means implementing measures which will bolster confidence, strengthen the conditions for medium-term growth, and address urgent social priorities, while at the same time ensuring that the medium-term objectives of fiscal balance and price stability are not compromised.

The 1990-1991 recession

The recession placed substantial upward pressure on the fiscal situation in both 1990-91 and 1991-92, resulting in substantially lower revenues and higher unemployment insurance payments. Sizeable slippage in the original deficit targets for these two years would have occurred if these factors had been allowed to flow fully through to the fiscal bottom line.

To contain slippage, program spending, excluding unemployment insurance payments, has been kept in check through the Expenditure Control Plan which was introduced in the February 1990 budget and extended and broadened in the February 1991 budget. Further substantial actions were taken to manage revenues and expenditures towards budget targets through the course of the past year. These included, for example, the January 1, 1992 increase in unemployment insurance premium rates to maintain the financial integrity of the Unemployment Insurance Account, the recently announced year-end freeze on discretionary spending and the government's decision, now before Parliament, to fully fund public service pensions. The actions permitted the federal government to realize a deficit outcome for 1990-91 that was effectively on the budget target of $30.5 billion. As well, they have made it possible to hold the 1991-92 deficit to $31.4 billion.

Recent actions to bolster the economy

The government responded to the unexpected economic weakness in late 1991 in a number of ways. Of greatest impact, particularly as their effects work through the normal lags in the economy, are the large declines in interest rates and inflation. Interest rates are significantly lower than at the time of the February 1991 budget, inflation is dramatically lower and the dollar has moved down substantially from its 1991 peak levels, all providing support for economic growth. In addition:

- In November 1991, the government introduced additional assistance to the agricultural sector.
- Tax assistance has been provided to the transportation sector.
- Additional financial support was announced for the publishing industry.
- The structure of the equalization program for lower-income provinces has been enriched by some $400 million in 1992-93 and $200 million per year thereafter.
- Assistance has been provided to the aerospace sector through government support for de Havilland.
- To assist the housing sector, the minimum downpayment for CMHC-insured mortgages has been reduced to 5 per cent for first-time home buyers for a period of two years.
- A series of measures has been announced to level the playing field for Canadian retailers vis-à-vis their cross-border American counterparts.

Actions in the budget to build confidence and competitiveness

Notwithstanding the sizeable pressures on revenues from the weaker-than-expected economy, this budget contains a fiscal track that shows substantial year-to-year declines in the deficit in both 1992-93 and 1993-94, and zero financial requirements by 1995-96. Reducing Canadians' tax burdens while at the same time reducing the deficit and maintaining the conditions for low inflation is the essence of the fiscal plan of the 1992 budget. This requires substantial reductions in federal government spending – $7.3 billion over the fiscal framework to 1996-97.

Within this fiscal track, the government is acting to improve competitiveness, to bolster the confidence of households in Canada's medium-term economic prospects and to enhance and better target support to families with children, particularly low- and middle-income Canadian families. These actions are being financed by the reallocation of resources from lower priority to higher priority areas.

A number of specific tax measures are proposed to improve the competitiveness of Canadian manufacturers. Consolidation and enrichment of the child benefit system will direct an additional $2.2 billion to families with children over the next five years. As well, over the same period, reductions in the personal income surtaxes will lower individuals' tax burdens by almost $7 billion. Additional assistance is being proposed for students, the disabled, and home buyers.

- Specific tax measures to assist the business community in meeting the challenges of global restructuring and competition include:
  - Reducing the manufacturing and processing tax rate from 23 per cent to 22 per cent effective January 1, 1993, with a further one percentage point reduction to 21 per cent on January 1, 1994.
  - Increasing the capital cost allowance rate for eligible manufacturing and processing machinery and equipment from 25 per cent to 30 per cent.
  - Streamlining the tax treatment of Scientific Research and Experimental Development expenditures.
- Measures to assist companies in obtaining adequate financing to meet both long-term capital investment needs as well as short-term cash-flow difficulties include:
  - Negotiate reducing the withholding tax on direct dividends to 5 per cent.

  - Targeting the life-time capital gains exemption to more productive investment.
  - Introducing a small business financing program for firms in need.
  - Enhancing support for labour-sponsored venture capital funds.
  - Increasing the maximum loan outstanding under the *Small Business Loans Act* to $200,000 from $100,000.
- To assist the recovery, particularly in housing, construction and related industries:
  - Individuals will be allowed to withdraw up to $20,000 from their RRSPs for the purchase of a principal residence; this measure will be in place for one year and monies withdrawn will be subject to a 15-year repayment period.
- To improve confidence in Canada's medium-term growth prospects:
  - Personal income taxes will be reduced. The general personal income surtax is being reduced by one percentage point on July 1, 1992 and a further one percentage point on January 1, 1993.
- To assist families with children, particularly those with low and middle incomes:
  - The child benefit system is being restructured and substantially enriched to provide an enhanced and consolidated child tax benefit which will be paid on a monthly basis. The child care deduction is also being increased.
- A number of tax modifications are proposed to assist the disabled. The list of eligible expenses for the medical expense tax credit will be expanded; the education credit will be made available to those with disabilities who attend a post-secondary institute on a part-time basis; the list of eligible expenses for disability-related modifications to existing buildings will be enlarged and the definition of earned income for pension purposes will be broadened. These build upon the significant measures introduced in previous budgets.
- Additional assistance to students will be provided through an increase in the education credit.

To pay for the net reduction in Canadians' tax burdens proposed in this budget, there will be substantial reductions in government spending and a streamlining of government operations totalling $7.3 billion over the 1992-93 to 1996-97 period. The Expenditure Control Plan, first introduced in the February 1990 budget and extended in the February 1991 budget, is being further broadened and deepened. These actions include:

- The Prime Minister and all Ministers will take a 5 per cent reduction in their ministerial salaries effective April 1, 1992.
- Departmental non-salary operating budgets are being reduced by 3 per cent from planned levels, or $150 million per year, over the 1992-93 to 1996-97 period.
- Tighter travel guidelines for Parliamentarians and public servants to reduce costs.
- Reductions in departments' communications budgets of $75 million per year.
- Defence spending is being cut by $2.2 billion over the 1992-93 to 1996-97 period.
- The growth in Canada Mortgage and Housing spending on social housing will be constrained to 3 per cent per year on average from 1992-93 to 1996-97. No new commitments will be made through the co-operative housing program after February 25, 1992.
- Forty-six separate government entities will be affected by streamlining. This includes 24 agencies, boards and commissions that will be wound up or merged; a further

13 ministerial advisory bodies will be wound up or merged; a number of other boards will be deferred; and several government holdings will be privatized.

- Program spending reductions across a wide number of departments, totalling $170 million in 1992-93, will be implemented.
- An enhanced program for asset disposal, particularly for government-held land, will be put in place. There will be further privatizations of Crown corporations.
- Cost recovery and collection of outstanding tax liabilities are being enhanced, and management systems are being strengthened.

At the same time, the government is moving to provide more "responsive, client-oriented" government services. These actions include:

- Federal departments and agencies offering services to individuals and businesses are being instructed to provide those services through common points of service delivery. The objective is to move towards one-stop shopping for federal government services for Canadians.
- Simplification of procedures for dealing with the federal government such as a single business registration number and simplified tax forms, more automated procurement and a simplified veterans' independence program claims system to highlight a few.
- Departments will begin to develop and publish standards for service, based on consultations with clients. These standards will result, for example, in government offices that provide services to the public having longer hours and faster responses, simpler forms and fewer of them.
- Existing government regulations will be "rejustified" by each government department and the government will ask the Standing Committee on Finance to review the existing federal regulatory programs and report by September 30, 1992 on ways to reduce the regulatory burden.

The fiscal outlook

Economic growth in late 1991 and through the first half of 1992 will be weaker than forecast in the February 1991 budget. As in many G-7 countries, this results in substantially lower tax revenues, especially personal and corporate income taxes, and higher unemployment insurance benefit payments. At the same time, interest rates have declined since the February 1991 budget and this reduces public debt charges and provides a partial offset to the deficit pressure. To minimize the fiscal slippage, a number of initiatives were introduced during 1991-92 – internal management economies were put in place, reserves were reduced, public service discretionary operating spending and hiring were frozen at year end, unemployment insurance premiums were increased, and legislation to fully fund public sector pensions was tabled.

These developments, together with the measures proposed in this budget and the end of the transition costs associated with the GST, will result in the deficit declining by about $4 billion in 1992-93 to $27.5 billion. Substantially weaker tax revenues account for the difference from the 1991 budget target of a deficit under $25 billion in 1992-93. Based on the measures introduced in this budget, and prudent economic assumptions (see Chapter 2), the deficit will decline by a further $5 billion to $22.5 billion in 1993-94 and continue to decline sharply thereafter. Relative to the size of the economy, the deficit reductions will be even more sizeable (see Chart 3.1).

Financial requirements will fall to less than $20 billion next year and just under $14 billion in 1993-94. Financial requirements will be in surplus in 1995-96, one year later than projected in the 1991 budget due to the ongoing impacts of weaker-than-expected tax revenues (and associated loss carry-forwards). The continuation of strict restraint on program spending growth combined with the ongoing impacts of recent and prospective interest rate declines will be the driving forces behind progress toward better fiscal balance. The surplus on the Operating Balance continues to grow (see Chart 3.2). The Summary Statement of Transactions, for the fiscal framework period, 1991-92 to 1996-97, is shown in Table 3.1.

The fiscal projections are based upon the structure of spending and revenues set out in this budget and the view of economic developments described in Chapter 2. Pressures may arise to spend more money in various areas due to a variety of factors. Considering the critical need to adhere to the path towards fiscal balance, such pressures, for the most part, can not be satisfied or will have to be funded through additional expenditure reallocations.

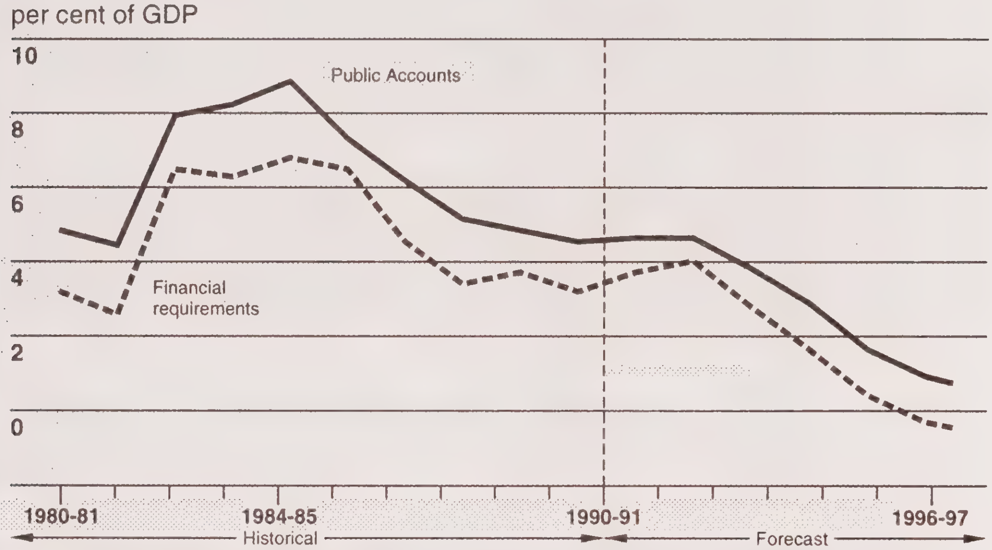
Table 3.1
Summary statement of transactions: Budget 1992

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
	(millions of dollars)					
Budgetary transactions						
Budgetary revenues	124,100	132,100	138,800	151,200	161,300	167,800
Program spending	-114,000	-119,400	-119,850	-124,100	-128,050	-132,000
Operating balance	10,100	12,700	18,950	27,100	33,250	35,800
Public debt charges	-41,500	-40,200	-41,450	-41,600	-41,750	-41,300
Budgetary deficit	-31,400	-27,500	-22,500	-14,500	-8,500	-5,500
Non-budgetary transactions						
Loans, investments and advances	200	400	500	300	300	300
Specified purpose accounts	4,500	7,200	7,800	8,300	8,800	9,400
Other transactions	-800	200	900	1,200	1,000	1,000
Net source of funds	3,900	7,800	9,200	9,800	10,100	10,700
Financial requirements (excluding foreign exchange)	-27,500	-19,700	-13,300	-4,700	1,600	5,200
Net public debt (billions of dollars)	419.8	447.3	469.8	484.3	492.8	498.3
Gross domestic product (billions of dollars)	683.4	713.6	769.2	828.3	887.2	945.6
	(percentage of GDP)					
Budgetary revenues	18.2	18.5	18.0	18.1	18.1	17.6
Program spending	-16.7	-16.7	-15.5	-14.9	-14.3	-13.9
Operating balance	1.5	1.8	2.5	3.3	3.7	3.8
Public debt charges	-6.1	-5.6	-5.4	-5.0	-4.7	-4.3
Budgetary expenditures	-22.8	-22.3	-20.9	-19.9	-19.0	-18.2
Deficit	-4.6	-3.8	-2.9	-1.7	-1.0	-0.6
Financial requirements	-4.0	-2.8	-1.7	-0.6	0.2	0.5
Net public debt	61.5	62.6	60.9	58.1	55.2	52.4

Note:

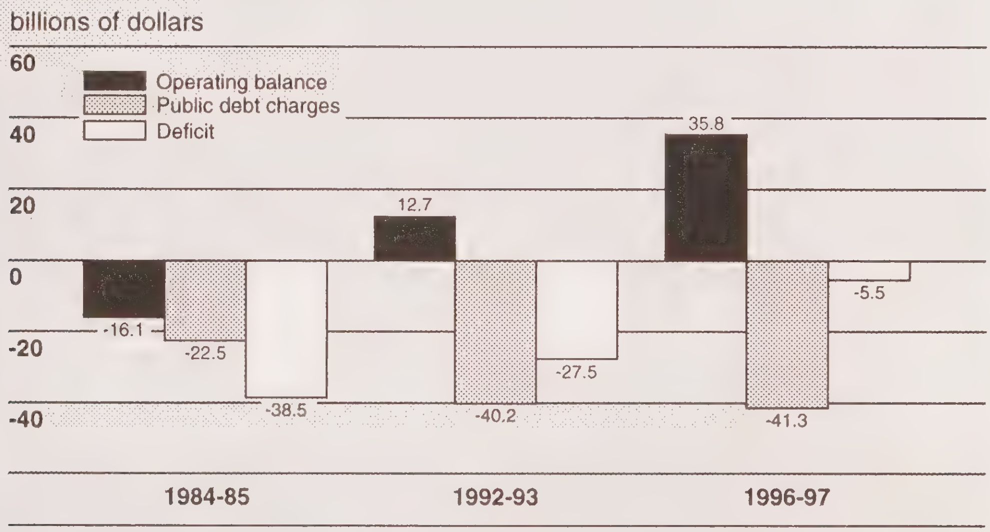
(-) indicates a net requirement for funds.
(+) indicates a source of funds.

Chart 3.1
The budgetary deficit and financial requirements[1]
1980-81 to 1996-97



[1] Excluding foreign exchange transactions.

Chart 3.2
The budgetary deficit, public debt charges and the operating balance[1]



[1] Operating balance is the budgetary deficit excluding public debt charges, i.e. budgetary revenues less program spending.

THE FISCAL RECORD: 1984-85 TO 1989-90

Strong and durable economic performance in Canada requires the setting of an appropriate macroeconomic environment within which the private sector can plan, invest, expand, hire, and profit. A sound fiscal situation is a key element of such an environment.

In 1984, the government faced a serious fiscal challenge – in effect, the fiscal affairs of the federal government were out of control. The deficit had risen to 8.7 per cent of GDP; total federal government expenditures had reached almost 25 per cent of GDP; and, the federal debt was growing at a rate of over 20 per cent per year. A vigorous response was required.

During the period 1984-85 to 1989-90, the process of fiscal consolidation made significant progress. The deficit was reduced from $38.5 billion to $29 billion, or from 8.7 per cent of gross domestic product (GDP) to 4.5 per cent (see Chart 3.3). Success was particularly evident in restraining federal program expenditures, the cornerstone of the fiscal strategy. Program spending declined to 16.0 per cent of GDP in 1989-90 from over 19.6 per cent in 1984-85 (see Chart 3.4).

Cuts in the operating budgets of government departments were effected through management initiatives to increase efficiency and reduce waste. The number of federal government person-years was cut by 10,000. Effort was also made to put the operations of government on a more business-like basis: greater cost recovery was undertaken in the areas of transportation services, inspection services, communications and publications. Subsidies, which can distort market incentives to the private sector, interventionist energy programs, social transfers to the well-to-do and transfers to the provinces were either reduced or their rate of growth was strictly curtailed.

Revenue increases were also implemented. The decline in the revenue yield – budgetary revenues as a share of GDP – in the late 1970s and early 1980s contributed considerably to increasing the deficit. The revenue yield fell from a peak of 19.2 per cent in 1974-75 to 16 per cent in 1984-85. The decline reflected a proliferation of tax expenditures, tax cuts, endemic flaws in the manufacturers' sales tax that led to steady erosion of the tax base, and effects of the 1981-1982 recession. As a result of measures adopted in various budgets after 1984, the revenue yield was gradually restored to 17.5 per cent by 1989-90, about the average of the 1970s.

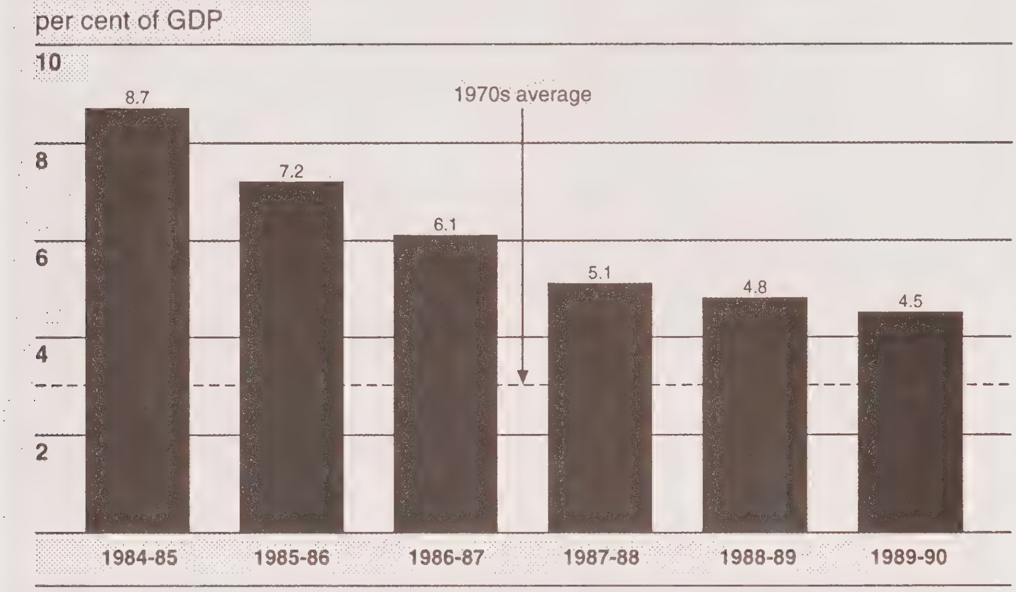
The improvement in the operating balance – the difference between program spending and revenues – was particularly dramatic. In 1984-85, a shortfall of $16.1 billion between what the government was receiving in revenues and spending on programs had developed. Because of the actions introduced since 1984, however, the operating balance swung from this $16.1 billion deficit to a surplus of almost $10 billion in 1989-90. About three quarters of this $26 billion improvement was due to expenditure restraint.

But, rapid growth of debt charges after 1985, reflecting the impact of increases in interest rates on the dangerous dynamics of deficits and debt, took up much of the fiscal gains from program spending restraint. Of the $26.1 billion improvement in the operating balance between 1984-85 and 1989-90, roughly $16 billion was required simply to pay the increased interest charges on the public debt, leaving only $10 billion to reduce the deficit.

FISCAL FRAMEWORK UNDER STRESS: RECESSION IN 1990 AND 1991

The fiscal situation in recent years has been subjected to a number of difficult economic shocks. Beginning in 1989, rapidly rising inflation pressures and the inevitable impact on interest rates resulted in substantially higher public debt charges. In addition, the

Chart 3.3
The budgetary deficit 1984-85 to 1989-90



economy entered recession in the second quarter of 1990 putting substantial pressure on the cyclically sensitive components of federal government revenues and expenditures.

In the face of these pressures, the government took tough actions to prevent a serious deterioration of the fiscal situation and to provide greater assurance that the medium-term fiscal anchors established in the April 1989 budget would be realized. An Expenditure Control Plan was introduced in the February 1990 budget. This Plan was extended and significantly broadened in the February 1991 budget.

Under the Expenditure Control Plan, spending in every major area except major transfers to persons, equalization payments and Canada Assistance Plan payments to equalization-receiving provinces was reduced, frozen at 1989-90 levels or limited in its growth. Table 3.2 shows the deficit reduction flowing from the Expenditure Control Plan as developed through the 1990 and 1991 budgets. Total cumulative savings from the Expenditure Control Plan including associated debt interest savings are estimated at over $39 billion over the period to 1995-96.

Table 3.2

The Expenditure Control Plan: Direct fiscal impact of measures announced in February 1990 and February 1991 budgets[1]

	1990-91	1991-92	1992-93	Cumulative savings to 1995-96
	(millions of dollars)			
A. Programs constrained				
Science and technology	38	1	–	39
Indian and Inuit programs	50	50	–	100
Canada Assistance Plan for non-equalization-receiving provinces	75	80	365	2,290
Defence	210	270	100	658
Official Development Assistance	116	190	339	2,375
Green Plan funding		125	100	600
Total	489	716	904	6,062
B. Programs frozen				
Established Programs Financing	869	1,541	1,932	11,429
PUITTA	16	34	48	361
Canadian Broadcasting Corporation	5	15		20
Canadian Film Development Corporation	6	7	7	41
Export Development Corporation	–	50	25	150
Marine Atlantic	4	5	5	29
Total	900	1,652	2,017	12,030
C. Programs reduced				
Grants and contributions	35	210	157	858
Canada Mortgage and Housing Corporation	16	67	109	614
Small craft harbours	4	5	5	29
Total	54	282	271	1,501
D. Programs/projects eliminated				
Canadian Exploration Incentive Program	50	125	193	1,034
OSLO	–	46	129	602
Polar 8 Icebreaker	84	62	21	373
Total	134	233	343	2,009
E. Measures affecting operations of government				
Crown corporations	401	185	43	794
Management efficiencies				
Operating budgets	180	835	1,020	5,620
Cost recovery	64	120	156	1,073
Tax compliance	167	330	430	2,702
Other	451	130	146	1,379
Total	1,263	1,599	1,794	11,568
F. Associated debt interest savings	125	450	750	6,000
G. Expenditure Control Plan savings	2,965	4,931	6,078	39,170

[1] The fiscal impacts presented in this table are based upon estimates made at the time of the 1990 and 1991 budgets. The actual fiscal impacts, ex post, may be different.

The February 1991 budget introduced a number of other measures aimed at improving the economic and fiscal situation. A key aspect was the joint announcement of inflation targets by the Government of Canada and the Bank of Canada. The government also introduced, in the February 1991 budget, the *Spending Control Act* and the *Debt Servicing and Reduction Fund Act*. The proposed *Spending Control Act* puts legislated limits on program spending for the period 1991-92 to 1995-96 at the levels projected in the

February 1991 budget. The Debt Servicing and Reduction Fund, to which is credited net GST revenues, net proceeds from privatization and gifts to the Crown earmarked to debt charges, was also introduced. Operating together, the *Spending Control Act* and the Debt Servicing and Reduction Account are key elements of the fiscal framework which are designed to ensure that higher program spending cannot be funded by higher taxes.

The February 1991 budget set a deficit target of $30.5 billion for 1991-92. However, the economy has turned out to be weaker than expected, particularly for personal and corporate incomes, and this has placed severe pressure on tax revenues, as well as creating a large and rapidly growing deficit in the Unemployment Insurance Account.

To contain these fiscal pressures, the government undertook a number of measures through the course of the 1991-92 fiscal year:

- The government legislated a freeze on civil servant salaries in 1991-92 and a 3 per cent increase in 1992-93.
- Internal reserves were applied against the fiscal pressures rather than new initiatives.
- Unemployment Insurance premiums were increased, effective January 1, 1992, to put the UI Account on a more stable financial footing.
- Lower-than-expected inflation provided a sizeable reduction in the actuarial estimate of future pension liabilities.
- A freeze on discretionary operating budget expenditures and new hiring was implemented on January 27, 1992 for the balance of the fiscal year.
- Legislation to provide for the full funding of public service pensions was introduced.[1]

As well, interest rates are lower than expected, providing a partial offset to the fiscal pressures from lower personal and corporate tax revenues and higher deficits in the Unemployment Insurance Account. Notwithstanding the actions, which will result in program spending growth significantly below the February 1991 budget projection, and the savings on debt charges, weakness in revenues resulted in an upward revision in the fiscal deficit target for 1991-92 to $31.4 billion, or 4.6 per cent of GDP. An operating balance surplus of $10.1 billion will be achieved for the 1991-92 fiscal year. Program spending growth, driven largely by unemployment insurance payments, will be up 6.1 per cent; excluding unemployment insurance benefits, the growth rate will be 3.3 per cent. Public debt servicing costs in 1991-92 will actually be lower than in 1990-91 – the first year-over-year decline since 1956-57.

Deficit control and expenditure restraint at the federal government level has not been matched by the provincial government sector as a whole in 1991 and 1992. On a public accounts basis, the aggregate provincial deficit is estimated to increase by almost $10 billion from 1990-91 to 1991-92, or 1.5 percentage points of GDP. To finance the increased borrowing requirements, provinces tripled their borrowing outside of Canada in 1991 to almost $18 billion. This placed upward pressure on the Canadian dollar and added to strains on capital markets and financial uncertainty.

Governments of other countries have also found it difficult to maintain deficit targets in the face of the 1990-1991 recession (see Annex to this chapter). The U.S. federal government deficit is forecast to rise from 3 per cent of GDP in the 1988-89 fiscal year, to

[1] The fiscal framework set out in this budget is prepared on the basis that the proposed pension legislation introduced by the President of the Treasury Board is passed by Parliament.

6.8 per cent of GDP, or U.S. $399 billion in the 1991-92 fiscal year. According to OECD estimates, the budget balance of the central government sector in the United Kingdom worsened by about 2½ percentage points of GDP between 1989 and 1991, while the budget balance for the German federal government worsened by over 1¼ percentage points.

RESULTS OF SPENDING RESTRAINT SINCE 1984

Canada's fiscal problem in 1984-85 – and the source of the debt burden we now have to bear – was a basic structural imbalance between spending on programs and revenues. In 1984-85, for each dollar the government received from taxpayers, it spent $1.33 on programs. While getting more than you pay for may seem like a good deal at the time, there is always a day of reckoning – be it for a government or a family. The first step in that reckoning is rapidly growing debt, followed by soaring debt servicing costs that consume an ever-growing proportion of revenues. Such is the dangerous dynamics of deficits and debt that Canada fell into in the 1970s and early 1980s.

To halt the rising debt burden meant first and foremost fixing the basic imbalance between revenues and spending. But major structural imbalances take time to correct, particularly when Canadians had grown accustomed to receiving a wide range of services that were financed by debt rather than revenues. Cutting back takes time, but compounding interest doesn't wait for anyone.

Between 1984-85 and 1991-92, the government eliminated, restrained and reduced a wide range of government programs. Table 3.3 sets out the record on expenditure restraint over the 1984-85 to 1991-92 period. Over this seven year period, total budgetary expenditures increased an average 5.1 per cent a year. The cost of servicing the public debt increased on average by 9.1 per cent a year. Program spending – that is spending excluding public debt charges – rose 3.9 per cent a year, much less than the 4.6 per cent average rate of CPI inflation and substantially below the 6.3 per cent average growth in nominal GDP.

While the restraint on expenditures has been quite broadly based, government operating costs – basically salaries and the goods and services government departments purchase – have been significantly restrained. These expenditures have grown on average 2.2 per cent per year since 1984-85 compared to average growth of 4.2 per cent for non-operating program spending.

Transfers to business – basically subsidies – have been cut in half since 1984-85. The decline is concentrated in the energy sector due to termination of subsidies under the National Energy Program. The government has also cut its support to major Crown corporations. Canada Post Corporation was made self-sufficient. The heavy water plants in Cape Breton were closed and passenger rail services were rationalized. In addition, growth in subsidies to the Canadian Broadcasting Corporation has been scaled back, funding for the Canadian Film Development Corporation and the concessional export funding activities of the Export Development Corporation have been frozen for both 1990-91 and 1991-92. Funds for new social housing by the Canada Mortgage and Housing Corporation were reduced from planned levels beginning in 1990-91. As a result, payments to major Crown corporations were lower in 1991-92 than in 1984-85.

Restraint on program spending has played the major role in reducing the deficit since 1984-85. Annual average spending growth was held to 3.9 per cent – a dramatic decline over the 13.8 per cent annual growth rate over the previous ten years. Looking ahead,

program spending growth will be held to an average growth rate of 3 per cent (see Chart 3.5).

At the same time, program restraint has permitted the reallocation of resources to priorities and absorbed the impacts of fiscal pressures (e.g. rises in debt service) while living within the overall fiscal objectives. In this regard, the government has provided growing support for certain priority areas. For example:

- Transfer payments to the elderly have grown at an average annual pace of 7.1 per cent, or about $1 billion per year, reflecting increases in the population base and full indexation of benefits to inflation.
- Direct cash support for science and technology has grown 7.1 per cent per year.
- Among the transfers to other groups, Indian and Inuit programs have grown 10.8 per cent per annum on average, in good part due to increases in the eligible population.
- Agriculture subsidies have increased 9.5 per cent per annum due to the need to address very depressed commodity prices which in turn have depressed market income levels.
- Transfers to student loans have grown 12.2 per cent per year.
- Funding for training, both through the Canadian Jobs Strategy and more recently delivered through the Unemployment Insurance Program, under the Labour Force Development Strategy, was just over $2 billion a year through the late 1980s, rose to $3.1 billion in 1991-92 and will rise to $3.4 billion in 1992-93.
- Federal government transfers to the provinces through cash payments and the transfer of tax points increased at a 5.4 per cent annual rate – much more rapidly than total program spending.

Table 3.3
Budgetary expenditures: 1984-85 to 1991-92

	1984-85	1991-92	Absolute change	Annual average growth
	(billions of dollars)			(per cent)
Major transfers to persons	25.1	41.0	15.9	7.3
Elderly benefits	11.4	18.5	7.1	7.1
Unemployment insurance benefits	10.1	18.2	8.1	8.8
Major transfers to other levels of government	18.8	24.1	5.3	3.6
(Cash and tax transfers to other levels of government)[1]	(25.6)	(37.0)	(11.4)	(5.4)
Other major transfers	11.9	12.3	0.4	0.5
to business	5.6	2.6	-3.0	-10.3
to other groups	6.3	9.7	3.4	6.4
Payments to major Crown corporations	5.8	4.6	-1.2	-3.2
Defence	8.8	12.2	3.4	4.8
Official Development Assistance	2.1	2.8	0.7	4.0
Operations of government	14.7	17.1	2.4	2.2
Program spending	87.1	114.0	26.9	3.9
Public debt charges	22.5	41.5	19.0	9.1
Total budgetary expenditures	**109.6**	**155.5**	**45.9**	**5.1**
Consumer price index (CPI)				4.6
Nominal GDP				6.3

Note: Figures may not add due to rounding.

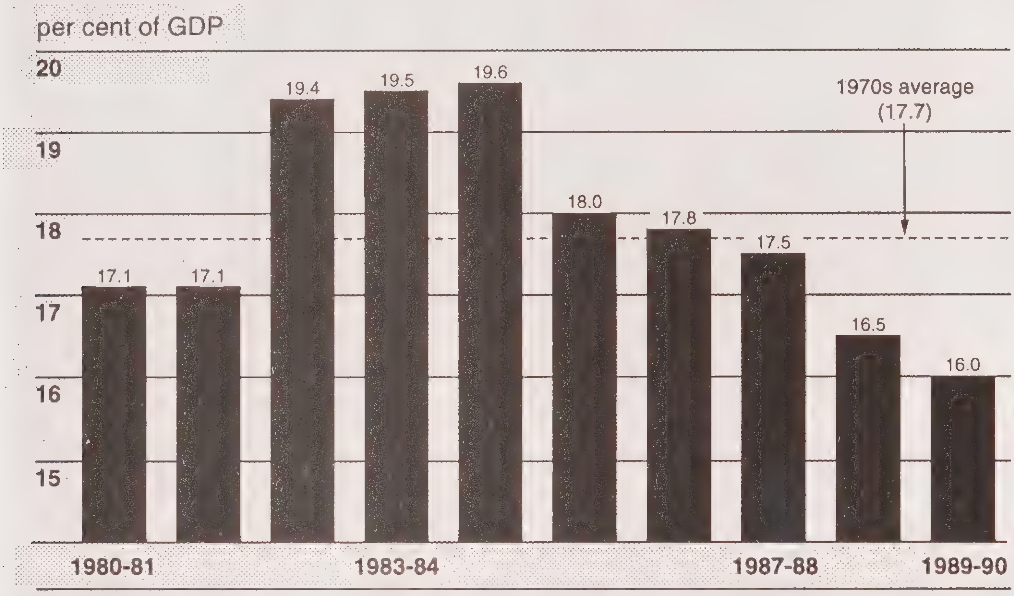
[1] Certain transfers to other levels of government are made as a combination of cash and a transfer of tax points.

THE FISCAL CHALLENGE FOR THE 1992 BUDGET

The fiscal challenge is to manage short-term pressures in order to stay on course toward the realization of the medium-term economic and fiscal goals. Staying on course will continue to send an important message of confidence for the private sector that the federal government has the will to move decisively toward fiscal balance. This will contribute to lower inflation expectations, lower interest rates, lower tax burdens, and higher economic growth and job creation.

Within this framework, it is important to address key priorities. Early recovery and sustained growth can be enhanced by carefully targeted measures that assist consumer and investor confidence.

Chart 3.4
Program expenditures 1980-81 to 1989-90



The fiscal plan underlying this budget has a number of objectives:

- achieving medium-term fiscal balance;
- streamlining government and improving service to the public;
- bolstering economic growth prospects with measures to enhance competitiveness and prosperity; and
- addressing the needs of families and the disabled.

EXTENDING THE EXPENDITURE CONTROL PLAN

The Expenditure Control Plan is further broadened and deepened with the proposals in this budget. The Plan continues to exempt a limited number of programs to ensure that limited government spending is directed to the highest priorities. These exempted areas include major social transfers (elderly benefits, family benefits, veterans' allowances and pensions, unemployment insurance benefits) and certain major transfers to provinces (equalization and Canada Assistance Plan transfers to equalization-receiving provinces).

The extension and broadening of the Expenditure Control Plan does not impose any additional limits on the major transfers to provinces.

In the February 1991 budget, the Expenditure Control Plan limited the annual rate of growth of cash for Official Development Assistance (ODA) and other international assistance initiatives to 3 per cent per year. As well, the annual rate of growth of support for science and technology initiatives was 3 per cent per year, beginning in 1992-93. This 3 per cent annual growth limit remains in effect in the current Plan. This is above the projected average rate of inflation and hence implies growth in real terms for these programs.

The Expenditure Control Plan will impact on all other components of program spending, but most specifically the operating costs of government. Departmental non-wage operating budgets were frozen at their 1990-91 levels in 1991-92. From 1992-93 through 1996-97, they will be reduced from planned levels by 3 per cent in each year. The wage policy, which was introduced in the last budget, remains in effect. Spending on communications will be reduced by $75 million per year. New guidelines will place restrictions on travel for both Parliamentarians and public servants to reduce costs. The ministerial salaries of the Prime Minister and Cabinet Ministers are being reduced by 5 per cent, effective April 1, 1992.

Major initiatives are being introduced to further streamline the operations of governments. Forty-six government entities – agencies, boards, commissions, and Ministerial advisory boards – are being eliminated, merged, deferred, or privatized to realize lower administrative and overhead costs, and to rationalize functions. Cost recovery and tax compliance initiatives are being strengthened in order to ensure that those directly receiving the benefit pay their fair share. The number of departmental publications is being cut and fee guidelines are being imposed for contract services. In addition, the government is undertaking a number of initiatives to better serve the public.

Details of the Expenditure Control Plan

The Expenditure Control Plan measures in this budget are expected to yield savings of $1.1 billion in 1992-93 and $1.2 billion in 1993-94. Over the five-year period, 1992-93 to 1996-97, the accumulated savings will amount to $7.3 billion.

Table 3.4
The Expenditure Control Plan

	1992-93	1993-94	Five-year savings
	(millions of dollars)		
1. Programs constrained			
Defence	258	272	2,185
Canada Mortgage and Housing	27	82	647
Student loans: savings from better management of default risks and termination of six-month post-graduation interest-free period	–	18	205
Green Plan funding: reprofiling	75	75	–
2. Reduction in grants and contributions and other programs	170	71	376
3. Streamlining government	12	18	97
4. Management initiatives			
Operating budgets	284	266	1,386
Cost recovery	26	39	216
Tax compliance	138	271	1,613
Privatization/asset management	60	88	563
5. Total fiscal impact of measures	1,050	1,200	7,288

A. Programs constrained

Defence

On September 17, 1991, the government enunciated a new defence policy designed to develop the essential core of the military capability necessary for Canadian security at home and the protection of Canadian interests abroad. The essence comprises three services – the Army, the Navy and the Air Force – organized as an integrated total force of Regulars and Reserves and one which promotes the essential combat skills. As the policy made clear, such a force must be balanced, well-trained and properly equipped. The target of 26 per cent of the defence budget for capital spending within five years will be pursued. The savings over the upcoming five years realized from the Defence Review were in excess of $1 billion, achieved primarily from the closure of two European bases, and a reduction in the size of the armed forces.

Since September 1991, the world has changed a great deal. The Soviet Union has ceased to exist and the conventional military threat in Europe has all but disappeared.

Without jeopardizing Canada's continuing commitment to NATO and the defence of Europe, the planned pull-out from Lahr and Baden can be advanced and a stationed task force of 1,100 personnel will not be necessary. A brigade and two CF-18 squadrons stationed in Canada will be ready to answer any call.

Furthermore, in the next two years, savings will be achieved in capital spending, research and development, public communications, administration, and through a rationalization of supply depots. The CF-18 Forward Operating Location at Kuujjuaq will not proceed at this time but the government will proceed with an alternative defence presence in Northern Quebec. The Canadian Forces Station at Bermuda will be closed.

In September 1991, when the government's new Defence policy was announced, significant potential infrastructure savings were foreseen. This is why an Advisory Group on Defence Infrastructure was established, to recommend a methodology by which the government could tackle the problem of redundant facilities. Their report is expected soon. The government will also review all land holdings in urban areas currently held by the Department of National Defence to determine whether significant benefits can be effected through their rationalization or disposal.

The measures announced in this budget will result in further sizeable savings, while preserving the core of essential defence capabilities. The combined savings of the September policy review and the measures announced in this budget will be $258 million in 1992-93, $272 million in 1993-94 and $2,185 million over the five-year fiscal planning period.

Canada Mortgage and Housing Corporation

Canada Mortgage and Housing Corporation provides funds under a variety of cost-sharing arrangements to assist Canadians who have difficulty finding affordable housing. Social housing expenditures have grown at an annual average rate of 6.5 per cent since 1984-85 and amount to about $2 billion in 1991-92.

The 1990 Expenditure Control Plan scaled back the rapid planned growth in funding for new social housing commitments by 15 per cent in 1990-91 and 1991-92. In the February 1991 budget, this constraint on growth was extended through 1995-96.

However, the projected rates of growth in total social housing spending still far outstrip the growth in total program spending. Without further action, the average annual rate of growth would be in excess of 5 per cent over the next five years.

Growth in social housing spending will be restrained to average 3 per cent per year from 1992-93 to 1996-97. This will provide $70 million for new social housing commitments in 1992-93 and $45 million in each subsequent year. Three per cent growth is consistent with the overall rate of growth in program spending and exceeds the projected rate of inflation. Savings of $622 million over five years will be realized. CMHC's social housing programs will continue to help provide housing for 650,000 Canadian families. The federal government also supports the housing needs of low-income families through the Canada Assistance Plan which it cost-shares with the provinces.

The Co-Operative Housing Program will be terminated immediately for additional savings of $25 million over the framework. The 14,000 housing units already built under this program will continue to be supported.

The housing sector will be positively affected by the impacts of lower interest rates on mortgage payments and developers' costs, the reduction to 5 per cent in the minimum downpayment required for a CMHC mortgage, and the special Home Buyers' Plan involving RRSP funds.

Green Plan

In December 1990, the government announced funding of $3 billion over five years for environmental initiatives. The $3 billion of funding for the Green Plan was extended to six years in the February 1991 budget.

The government remains committed to Green Plan funding of $3 billion over the period to 1996-97. However, given the pressures on the deficit, Green Plan allocations will be reduced by $75 million in both 1992-93 and 1993-94 with these savings being reprofiled to the ensuing three fiscal years.

Canada Student Loans

Under the Canada Student Loans Program, the federal government guarantees loans made by chartered banks and other designated lenders to eligible students attending post-secondary institutions in Canada. Each year, the Canada Student Loans Program provides $630 million in government guaranteed loans to over 215,000 students. While the student is in school and for the first six months after the student leaves school, the government pays interest on the loans outstanding.

The government will be negotiating with financial institutions new financing arrangements for the Canada Student Loans Program to reduce the growing cost of defaults and to improve the efficiency of the program. Lenders will be asked to share in the risks and costs of defaults – currently about $935 million of Canada Student Loans are in default and the risk is completely borne by the taxpayer. Negotiations are expected to result in a new rate structure for Canada Student Loans and lower costs to

the government. It is expected that this will provide scope to eliminate the 3 per cent guarantee fee on loans, and to increase limits on loans to needy students.

Starting with new loan guarantees made for the 1992-93 academic year, the six-month post-graduation interest subsidy will be eliminated. Interest will be applicable from the date the student leaves school. The first payment on the loan will continue to be six months after leaving school.

The government will update the formula which provides for payments to provinces which choose to establish their own student loan programs as an alternative to participating in the Canada Student Loans Program.

The government will be providing additional support for post-secondary students through an enrichment of the education credit. This is described in the Chapter 4.

The International Assistance Envelope

In the February 1991 budget, the International Assistance Envelope (IAE) was introduced. It includes funding for both Official Development Assistance (ODA) and other international assistance initiatives, particularly in Eastern Europe and the former U.S.S.R. IAE cash was constrained to annual growth of 3 per cent a year in 1992-93 and beyond in the February 1991 budget, and that limit is being maintained in the February 1992 budget, less the impact of the government-wide reduction in non-wage operating and communications budgets. This cash growth will fund both growing ODA cash disbursements and increasing assistance to Eastern Europe over the fiscal framework. In addition, the government intends to further reduce the costs of the Canadian International Development Agency's decentralized administration. These savings, which are estimated at about $20 million for 1993-94 and could grow over time, will increase the resources available for international assistance initiatives.

B. Reduction in grants and contributions and other programs

Reflecting the need to make the deficit reduction and expenditure restraint thrusts as broad as feasible, a wide spectrum of grants and contributions will be reduced. The savings will be $170 million in 1992-93, $71 million in 1993-94 and $376 million over the five-year period to 1996-97. Details on these measures will be contained in the Main Estimates. Some examples of the measures in this category follow.

The government recognizes the continuing need for job training and adjustment to help reintegrate the unemployed into the workforce and to meet the challenge of a competitive global environment. There will be an overall increase of $300 million available in 1992-93 for training and adjustment, bringing the total expenditures to $3.4 billion. This is a 50 per cent increase over the funding provided for training in 1990-91. Increasingly, training funds have been provided from the Unemployment Insurance Account, under the Labour Force Development Strategy – $1.8 billion in 1992 – to help unemployment insurance recipients acquire the skills they need for new jobs. For 1991-92, funding of $1.7 billion was made available for the Canadian Jobs Strategy. Permanent funding of $1.6 billion will be provided for 1992-93 and beyond.

Agriculture Canada will save about $20 million in each of the fiscal years 1992-93 and 1993-94 through a review of grants and contributions. The Department of Communications will reduce certain activities, including growth in museums and archaeology programs and funding for cultural infrastructure (a total of $35 million over the next five years). External Affairs will be reducing grants and contributions to a number

of international operations where the original objective is no longer applicable or is being met more effectively through other mechanisms ($21 million over five years). Indian Affairs and Northern Development will be restraining the growth in operating costs of organizations delivering programs ($133 million over five years). Industry, Science and Technology will be reducing their grants and contributions for a number of programs and delaying the start up of others ($9 million over five years). The Secretary of State's Canadian Exhibit Program will be eliminated ($21.5 million over five years).

C. Agencies eliminated or consolidated: Streamlining government

The Government of Canada comprises more than 400 separate organizations and advisory bodies. There are some 26 statutory departments, 80 departmental agencies, 56 Crown corporations and over 200 boards, tribunals, councils and other advisory bodies.

Each of these organizations was created to respond to a particular public need. Too often, the tendency has been to create a new body to respond to each set of new requirements. Over time, the number of these agencies has increased and insufficient effort has been made to consolidate or sunset where appropriate. Just as the private sector restructures to reduce costs, overlap, and duplication, so must governments. The government has decided, therefore, to rationalize wherever possible in the light of the following criteria:

- elimination of waste in overlap and duplication within government;
- elimination of waste in duplication with the private sector;
- the potential to strengthen particular sectors by consolidating related organizations and their mandates;
- the necessity of postponing desirable initiatives that cannot be afforded in current circumstances; and
- continued privatization of commercial operations which no longer serve a public policy purpose.

The government recognizes that many of the wind-ups and consolidations of agencies that it is announcing may be seen by those affected as signalling a reduced commitment to particular sectors. This is not the government's intention. It believes that Canadians generally will welcome an initiative to save taxpayers' dollars by eliminating non-essential functions, reducing overlap within government and with the private sector, and consolidating wherever possible.

- A total of 46 separate government entities are directly affected by these streamlining measures. These figures include:
    - 15 agencies, boards, and other government organizations will be wound up or folded into departments.
    - 13 Ministerial advisory boards will be wound up.
    - 9 agencies are being consolidated into four more efficient organizations.
    - 3 new agencies that had been announced or were in the process of being created will be put on hold until fiscal circumstances permit.
    - 2 corporate holdings/functions are being privatized. The government will also review the appropriateness and practicality of privatizing the Cape Breton Development Corporation, the Royal Canadian Mint and the Blainville Motor Vehicle Test Centre.
    - 1 agency will be converted to a departmental corporation.

Together, these changes will directly affect a total of approximately 1,200 employees, not including the four possible candidates for privatization. They will result in a reduction of approximately 15 full-time positions filled by the Governor-in-Council and another 145 part-time Governor-in-Council positions, and an estimated overall reduction of an additional 500 government employees. When all the wind-ups and consolidations are completed, total savings in salaries and benefits will amount to ongoing savings of some $22 million per year.

Table 3.5
Government streamlining

Wind Up

Canadian Institute for International Peace and Security
The Law Reform Commission
The International Centre for Ocean Development
The Veterans Land Administration
The Petroleum Monitoring Agency
The Agricultural Products Board
The Demographic Review Secretariat
CN (West Indies) Steamships Ltd.
The Science Council of Canada
The Economic Council of Canada
The Pay Research Bureau
Canadian Environmental Advisory Council
International Aviation Advisory Task Force and Committee
National Advisory Committee on Development Education
Canada Employment and Immigration Advisory Council
Advisory Council on Lay Members of the Competition Tribunal
Advisory Committee on La Francophonie
Advisory Committee on le Musée de la Nouvelle France
Montreal Science and Technology Museum Advisory Committee
Advisory Committee for le musée des arts et du spectacle vivant (de la scène)
Marine Advisory Board on Research and Development

Defer

Canadian Race Relations Foundation
Canadian Heritage Languages Institute
The Sentencing and Conditional Release Commission

Merge/consolidate

The Enterprise Cape Breton Corporation
Emergency Preparedness Canada
The International Development Research Centre (converted to departmental corporation)
The Patent Appeal Board, the Trade Marks Opposition Board and the Copyright Board
The RCMP External Review Committee and the RCMP Public Complaints Commission
The Canadian Commercial Corporation
The Privacy Commissioner and the Information Commissioner
The Procurement Review Board
The Canada Council, the Social Sciences and Humanities Research Council and International Cultural Programs
Communications Research Centre Advisory Committees (3)

Privatize

The Co-operative Energy Corporation
The Dosimetry Services Unit
The Cape Breton Development Corporation (examine)
The Royal Canadian Mint (examine)
The Blainville Motor Vehicle Test Centre (examine)

D. Management initiatives

Operating budget cut

Over the period 1987-88 to 1990-91, non-wage operating budgets of federal government departments were constrained in aggregate to 2 per cent growth per year. For fiscal year 1991-92, these costs were frozen at their 1990-91 levels. In this budget, an across-the-board cut in planned non-wage budgets of 3 per cent is applied. The total savings will be $150 million in 1992-93 and grow in later years. Wage budgets will continue to be constrained by the government's two-year wage strategy of 0 and 3 per cent. In subsequent years, wage settlements will continue to be constrained by the government's expenditure restraint and will be influenced by the low inflation environment.

Tighter government travel guidelines

As part of the realization of the 3 per cent across-the-board cut in non-wage operating budgets, changes in the guidelines surrounding government travel will be implemented. These amended guidelines will involve:

- no first class air travel;
- Deputy Ministers and Agency Heads to manage downward the use of business class travel;
- hotel accommodations will be restricted to the Treasury Board approved minimum level of accommodations. Higher cost accommodations will be limited to cases where it is cost effective or where personal circumstances warrant;
- continuing the 20 per cent reduction in travel outside continental North America introduced in the February 1990 budget;
- reducing the size of delegations to international meetings; and
- reducing participation in international meetings and conferences.

Communications budget cut

In addition to the across-the-board 3 per cent cut in non-wage operating budgets, departments' budgets for communications are being cut by $75 million per year in each of the next five years.

The savings will be realized through a new approach to the management of communications expenditures including centralization and streamlining a number of functions such as advertising and a "no frills" publishing policy. Departments and agencies will stop producing routine annual reports containing information that is generally set out in Part III of the Estimates. Crown corporations will continue to publish annual reports as they always have.

These measures will not deny the public access to information it needs on government programs. A general review of publication activities will ensure that only publications serving a demonstrated public need are produced. Departments will inject greater efficiencies in delivering relevant information and drastically reduce the number of non-essential publications.

Other operating budget cuts

The operating budgets of a number of departments will be reduced in addition to the government-wide 3 per cent reduction in non-wage operating budgets and in communications budgets. For example, Agriculture Canada will realize $30 million of savings over the next two fiscal years through deferral of facility refurbishing. Public Works Canada will reduce its costs for government accommodation by a total of $20 million over the same period, in good part through reducing the amount of leased space that the Department intends to acquire.

Privatization and asset management

Since 1984, the government has privatized or dissolved more than 20 Crown corporations and improved operations of the remainder. Through productivity gains, privatization and rationalization, the number of Crown corporation employees has been reduced by close to 80,000 since 1984-85.

In the coming year, the government will continue its objective of divesting itself of investments no longer required as instruments of public policy. The government will begin negotiations to sell its holdings in the Co-Operative Energy Corporation and will privatize National Health and Welfare's Dosimetry Unit. The government will also examine the feasibility on a priority basis of privatizing the Royal Canadian Mint, Cape Breton Development Corporation (DEVCO) and the Blainville Motor Vehicle Test Centre.

The government will speed up the pace of surplus property disposal. The government intends to sell the Dupont Chancery in Washington, the Cultural Centre in Paris, and the Canadian Consulate in Bordeaux. In addition, the government will be consulting with provincial and municipal authorities to seek ways to more aggressively dispose of surplus land in Canada, in particular surplus lands held by the Department of National Defence, including Downsview Ontario, and Transport Canada at Pickering.

Tax compliance and cost recovery

Revenue Canada (Taxation and Customs and Excise) will increase its compliance and collection activities with respect to revenues owing to the government. The existence of a large stock of owed but uncollected taxes is unfair to the majority of taxpayers who pay on time. As well, the uncollected taxes raise the deficit above what it should be with a given tax structure. Revenue Canada – Taxation will be undertaking more audits and will follow more persistent collection efforts to ensure that personal and corporate taxes that are owed are collected. In addition, the frequency of customs audits will be increased to enhance collection of prescribed duties and taxes on imported goods, thereby ensuring a level playing field for Canadian industry and retailers. Tax information slips will be issued to recipients of farm support payments to facilitate the reporting of such payments for tax purposes.

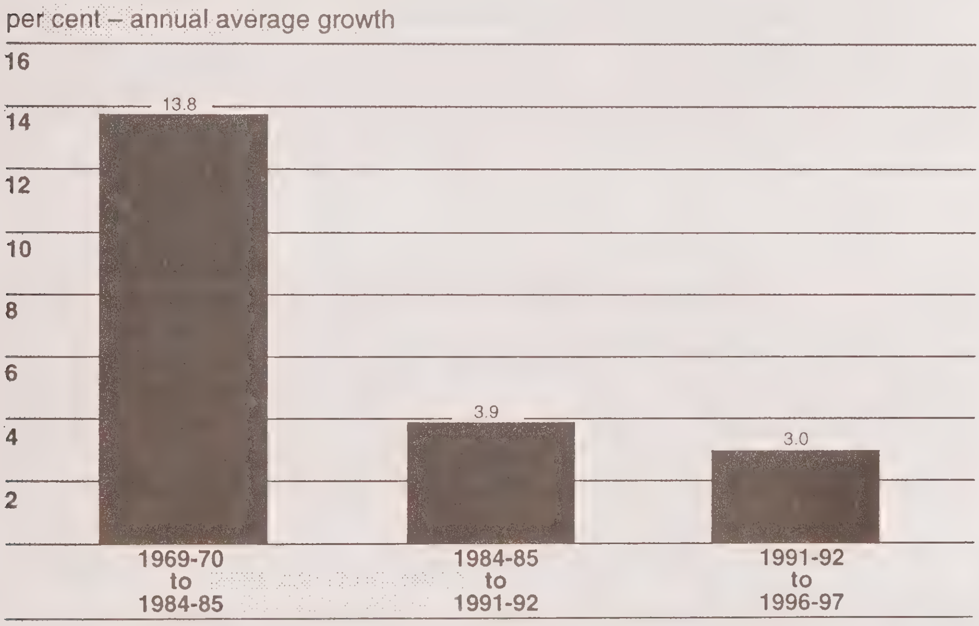
A number of other departments will increase efforts to recover funds owed to the government and to increase revenues. For example, Energy, Mines and Resources will be conducting more extensive audits to recover overpayments made to the oil and gas industry under the Petroleum Incentives Program. As well, the government will be seeking a dividend from the revenues generated from Telefilm Canada, the Cultural Industries Development Fund and the National Film Board's Independent Film Fund (a total of $55 million over the next five years).

MEASURES TO STRENGTHEN ECONOMIC PERFORMANCE

Securing sound economic fundamentals

Since 1984, the government has introduced important structural changes to improve the efficiency and potential of the Canadian economy. These include the Canada-United States Free Trade Agreement, income tax reform, the replacement of the Federal Sales Tax by the Goods and Services Tax, the Labour Force Development Strategy, privatization of Crown corporations, deregulation of the energy and transportation sectors and financial institutions reform. In the February 1991 budget, the government announced the Plan for Economic Recovery, designed to reduce inflation pressures, interest rates and the burden of public debt. The building blocks to support a sustained recovery are being put in place.

Chart 3.5
Growth in program spending



- Inflation pressures have been substantially reduced.
- Interest rates and monetary conditions have eased significantly over the course of the past year and will continue to ease if progress toward price stability is sustained.
- The federal government has taken measures to minimize the impact of the recession on the fiscal framework; as a result, unlike in early 1980, the fiscal situation will improve rapidly as growth recovers. Substantial declines in the deficit and program spending as a proportion of GDP have been realized and sizeable further progress in deficit reduction will be achieved in 1992-93 and beyond.
- Measures are being taken in this budget to support economic growth while continuing decisively towards eliminating the government's financial requirements by mid-decade.

Bolstering the economic recovery

In recent weeks, the government has also acted to assist two specific sectors – providing additional stimulus to the **housing sector** and proposing a number of measures to deal with the cross border shopping problem by levelling the playing field for Canadian retailers facing competition from U.S retailers.

Two additional measures are being introduced in this budget – a lowering of personal income taxes through a reduction in the personal income surtax and the introduction of the special Home Buyers' Plan. The personal income surtax will be reduced in two steps – from 5 per cent to 4 per cent effective July 1, 1992 and to 3 per cent effective January 1, 1993. This will increase personal disposable income by $0.5 billion in 1992-93, by $1.3 billion in 1993-94 and by $6.6 billion over the five-year period to 1996-97.

The special Home Buyers' Plan will allow home buyers to withdraw a maximum of $20,000 of registered retirement savings plan (RRSP) funds to finance the purchase of a principal residence, without having to pay tax on the withdrawal. To ensure that the role of the RRSP in providing funds for retirement is not compromised, those who participate will have to repay the amount withdrawn to their RRSP over 15 years. This measure will take effect immediately and will be available until March 1, 1993. It will stimulate home construction, activity in housing-related sectors, and job creation, at no significant fiscal cost.

Table 3.6
The fiscal impact of measures to bolster medium-term growth prospects

	1992-93	1993-94	Five-year impact to 1996-97
	(millions of dollars)		
1. Reduction in surtax	-500	-1,250	-6,645
2. Use of RRSP funds for home purchase	small fiscal costs		
3. Total fiscal impact	-500	-1,250	-6,645

Measures to enhance competitiveness

A competitive business sector is a necessary and essential element for long-term economic prosperity. **Future prosperity** is enhanced by measures to improve the productivity and competitiveness of Canadians in the face of global competition. A number of tax changes are being introduced in this budget to enhance the efficiency and competitiveness of the economy.

The manufacturing and processing sector is a key component of the Canadian economy. It is also in the process of restructuring to adapt to increased global competition. To assist this restructuring process, the government is proposing two changes to the corporate income tax system. First, the federal corporate tax rate applicable to Canadian manufacturing and processing income is to be reduced in two stages: from the present 23 per cent to 22 per cent on January 1, 1993 and to 21 per cent on January 1, 1994. Second, the capital cost allowance (CCA) for manufacturing and processing machinery

and equipment is to be increased from the present 25 per cent to 30 per cent for property acquired after February 25, 1992. These two measures will provide lasting benefits to the manufacturing and processing machinery and equipment industry and encourage investment in Canada.

The government is announcing that it is prepared, in negotiating new tax treaties, to reduce the withholding tax rate on direct dividends to 5 per cent. The current withholding tax rate varies by country, but is 10 per cent with most of our major trading partners. This increases the effective tax rate on earnings distributed by a Canadian subsidiary to its foreign parent and acts as an impediment to direct investment in Canada. Any rate reductions would be reciprocal, benefiting Canadian firms investing abroad as well as foreign firms investing in Canada.

The government is also proposing a number of measures to increase access to capital. The maximum national Labour-Sponsored Venture Capital Corporation Credit is to be increased from $700 to $1,000. In the case of provincial funds, the maximum credit matched by the federal government will be increased from $700 to $1,000. The asset limit on eligible investments will be increased from $35 million to $50 million and the eligibility criteria will be broadened. The lifetime capital gains exemption will be targeted towards productive investments by excluding its use for capital gains on real estate investment that occur after budget day. These two measures will provide greater support for productive investment.

To help small business in financial difficulty, the government will introduce the Small Business Financing (SBF) program, as a temporary measure. The SBF program will permit qualifying small businesses to borrow at interest rates below those normally charged in the commercial market, by treating the interest payments to the lender as dividends. This will permit lenders to charge lower interest rates while maintaining the same after-tax rates of return. In addition, the maximum amount of loans outstanding under the *Small Business Loans Act* (SBLA) will be increased from the present $100,000 to $200,000. The SBLA assists small business by providing guarantees on loans from conventional lenders.

Canada already has one of the most generous tax regimes for R&D in the world. The government has been consulting with business to determine if there are ways to improve the effectiveness of the program. These consultations have indicated that changes are possible to streamline the system of research and development tax credits in order to make current programs more effective. The specific proposals will be announced after the details have been discussed with the research and development community.

Table 3.7
The fiscal impact of measures to enhance competitiveness

		1992-93	1993-94	Five-year impact to 1996-97
		(millions of dollars)		
1.	Reduction in manufacturing and processing tax rate	–	-150	-1,550
2.	Increase in capital consumption allowance	-40	-110	-730
3.	Withholding tax changes	-10	-55	-430
4.	Increase LVCC incentive	–	-5	-20
5.	Redirect capital gains exemption	10	80	980
6.	Small business financing	-20	-20	-70
7.	Research and development	–	-50	-230
8.	Total	-60	-310	-2,050

MEASURES TO ADDRESS PRIORITIES OF FAMILIES AND THE DISABLED

Continuing to address the needs of families and the disabled is an important goal of the government. In this budget, the government is proposing a major reform of the child benefit system, which consolidates the various benefits currently in place and provides additional support to low- and middle-income families. It is also proposing to treat common-law couples the same as married couples for tax purposes. Additional support is being provided to the disabled, building on the initiatives in previous budgets. An increase in the education credit is also being proposed for post-secondary students.

Child tax benefit

The current family benefit system is composed of three separate programs. These are the monthly family allowance, the refundable child tax credit, and the non-refundable dependent child tax credit. The government proposes to introduce a new child tax benefit that incorporates an earned-income supplement that will provide additional benefits to low- and middle-income working families with children. The new enriched child tax benefit will be delivered on a monthly basis to all eligible recipients beginning in January 1993. Detailed information is provided in a White Paper to be released by The Honourable Benoît Bouchard, the Minister of National Health and Welfare.

The budget also proposes to increase by $1,000 the maximum expenses for child care that may be claimed for the 1993 and subsequent taxation years. Through the child care expense deduction, the government recognizes the costs incurred by single parents and families with both parents in the work force. Through this deduction, the federal government provides about $300 million in tax assistance to over 600,000 taxpayers, of whom three-quarters are women.

Tax treatment of common-law couples

The budget proposes to treat common-law couples the same as married couples for purposes of the tax system. As a result of this change, common-law couples will be

eligible for the married credit, required to combine their incomes for the determination of income-tested credits, and will be subject to other tax provisions that apply to married taxpayers.

Increase in education credit

Additional tax relief is being provided to students by increasing the education credit and the credit which may be transferred to parents and other supporting taxpayers. The budget proposes to increase the dollar limit on which the education credit is calculated by one-third, to $80 per month for students engaged in full-time study. It also increases the limit on the total amount of tuition fee and education credits that may be transferred to a supporting taxpayer to $680. These changes will be effective for the 1992 and subsequent taxation years.

Measures for Canadians with disabilities

Since 1984, the tax provisions applying to Canadians with disabilities have been considerably broadened and enriched. In this budget, the government is proposing a number of further tax changes to assist the disabled. The list of eligible expenses for the medical expense tax credit will be expanded; the education credit will be made available to those with disabilities who attend a post-secondary educational institute on a part-time basis; a number of items will be added to the list of expenses for disability-related modifications to existing buildings; and, the definition of "earned income" for purposes of contributing to an RRSP will be changed to include Canada Pension Plan/Quebec Pension Plan (CPP/QPP) disability pensions.

Table 3.8
The fiscal impact of measures to address priorities of families and the disabled

	1992-93	1993-94	Five-year impact
	(millions of dollars)		
1. Restructuring child benefits	-520	-645	-2,090
2. Increase child care expense deduction	–	-10	-135
3. Treat common-law as married for purposes of the *Income Tax Act*	–	180	985
4. Tax assistance for education	-10	-25	-110
5. Measures for the disabled	-5	-15	-75
6. Total	-535	-515	-1,425

Other tax measures

To encourage the development and use of ethanol and methanol fuels made from renewable feedstocks, the government proposes to eliminate, effective April 1, 1992, the excise tax on the ethanol and methanol portions of blended fuels that are mainly gasoline.

The government is reviewing the taxation of life insurance companies to ensure that they pay their fair share of federal tax. This is particularly important now since life insurance

companies are increasingly competing in markets with other financial institutions. The government will be outlining specific proposals over the next few months.

The phase-in of higher contribution limits for registered pension plans (RPP) and registered retirement savings plans (RRSP) will be delayed by one year. The registered retirement income fund (RRIF) provisions will be amended to permit RRIF withdrawals to extend over the remaining lifetime of the RRIF holder or the RRIF holder's spouse.

Effective for personal income tax returns filed for the 1992 taxation year, interest on refunds will not start to accumulate until 45 days after the filing deadline.

Table 3.9
The fiscal impact of other tax measures

	1992-93	1993-94	Five-year impact to 1996-97
	(millions of dollars)		
1. Elimination of excise tax on ethanol	-2	-2	-25
2. Taxation on life insurance companies	55	75	415
3. Delay in RRSP/RPP limits	–	20	320
4. Interest free processing period	–	55	220
5. Total	53	148	930

MEASURES TO PROMOTE IMPROVED GOVERNMENT SERVICE TO CANADIANS

Governments exist to serve citizens. One of the purposes of this budget is to direct scarce resources away from government overhead and toward better, more responsive and more client-oriented services for Canadians.

This requirement is most important at the point of service delivery. Canadians look to the federal government for a vast range of economic and social services. At present, there are literally thousands of different points of service across Canada provided by the 26 federal departments and scores of other government organizations. An enquiry about a pension matter, for example, could be the responsibility of several different departments, depending on the nature of the pension, and its tax implications belong to yet another. These different points of service are frustrating for citizens; certainly they are inefficient.

As well, it is imperative to make it easier for the public to deal with government – be it for paying taxes, for providing statistics, for obtaining information, for getting services, for responding to regulations, etc. The government is committed to providing more client-oriented service. To do these things, government also has to invest in its systems, in its training and its technology so that it restructures and modernizes in line with the global pressures on the private sector.

Co-location of services in urban centres and "single-window" services in smaller centres

Beginning immediately, federal departments and agencies offering services to individuals and to businesses are being instructed to, first, work together to provide more user-friendly service to their clients, and second, to take all reasonable steps to provide those services in sensible "clusters" through common points of service delivery. The President of the Treasury Board will carry overall responsibility for ensuring that this policy is implemented.

Departments providing services to the public are generally well-represented in larger urban areas. Where departments are not already co-located, they will move to do so in an orderly and cost-neutral way. This does not mean moving all federal public servants in a given city into a single building; that sort of massive relocation would not be cost-efficient. Rather, it means co-locating points of service delivery, in a rational way and over time, to provide better and more convenient service at the lowest possible cost.

- Some departments are already moving in this direction. National Health and Welfare, for example, is combining the existing regional offices of its different branches to provide "single-window" services to its clients throughout Canada.

In many smaller communities there may be only one federal office – often a Canada Employment Centre (CEC), of which there are some 550 located across the country. Service to Canadians will be greatly improved by using existing networks of departmental offices, such as the CECs, to provide information and services on behalf of several departments.

- This will include the provision of forms, and basic information on programs and services. In addition, departments will also use these "single-window" service centres as the site for regular "service clinics" which will give Canadians living in smaller centres access to a much broader range of federal services right in their own communities.

Making it easier to deal with the federal government

(i) Single business registration number

At present, different departments require as many as six different registration numbers from Canadian businesses. This means more work for businesses, more cost for government and, inevitably, poorer service. The government is committed to making the necessary changes to arrive at a single registration number in cases where this would be advantageous to the business concerned. This will mean less paperwork for business, greater efficiency and responsiveness by government, better economic statistics and a more effective system of revenue collection.

(ii) Service standards

Making services more accessible requires a new, client-centred approach to how departments do their business. It means such things as more flexible office hours so that Canadians can obtain services in the evening and on Saturdays; it means simpler forms, and fewer of them. It means fewer line-ups, and faster responses to telephone inquiries.

All departments providing services to the public are moving to adopt these kinds of measures over the coming months. Departments will now increasingly begin to develop and publish standards for service, based on consultation with clients, that clearly spell out service levels and costs. The President of the Treasury Board will carry overall responsibility for this initiative.

- The Department of Veterans Affairs operates a Veterans Independence or "VIP" Program. The department will reduce its costs, and minimize the burden on clients, by prepaying entitlements and having clients submit receipts for expenditures only once at the end of the year.
- Revenue Canada – Taxation has introduced "no-calculation" tax forms that simplify filing and returns. A similar saving in time and cost will result from the introduction of a new "T2 Short" tax form for businesses.
- By moving quickly to fully automated procurement, the Department of Supply and Services will reduce transaction costs and speed up the process of government procurement. This will largely be in place by the end of 1993. This new program, known as Acquisition 2000, will give line managers greater control over smaller purchases and provide easier access to government procurement information for suppliers.

(iii) Making greater use of private sector financial institutions

Where savings can be achieved through the administration of a program or service by private sector financial institutions, the government is prepared to do so.

- The Net Income Stabilization Account (NISA) provides for payments to farmers to stabilize income through periods of income swings. For greater efficiency the government is examining the practicality of transferring the administration of NISA to private sector financial institutions.
- The Veterans Land Administration (VLA) has been administering a now-declining portfolio of loans, currently valued at some $50 million, to veterans of World War II and Korea. The VLA will be wound up, and the Department of Veterans Affairs will consider ways to ensure the proper administration of that loan portfolio through the private sector while also ensuring that the interests of veterans are fully respected.

(iv) Greater efficiency in contracting and procurement

To reflect both the spirit of restraint and current market conditions, the government will freeze rates paid to its legal agents (i.e., outside legal counsel) for the coming fiscal year. It will also impose greater discipline on rates paid to other contractors and lessors.

As a further measure of efficiency, the Department of Supply and Services will move to "just in time" printing of forms. This will save warehousing costs currently estimated to run at several million dollars per year. Print-on-demand results in savings of 30 per cent for every form or other publication so produced.

Investing in managerial efficiencies in the federal public service

Although funds for investments in efficiency are limited, the government is prepared to make those investments where this can be shown to produce significant savings or improvements in efficiency and service. One key to this is the use of modern information management and technology including imaging, networking, electronic data interchanges and smart card technology. A number of examples are cited below:

- Maritime shippers can now file their bills of lading electronically in advance of shipping freight through Halifax, eliminating customs delays of many hours.
- Tax preparers can electronically file tax returns using Revenue Canada's E-File program; this service will soon be available to all Canadians.
- Magnetic stripe cards and point-of-sale terminals present in retail stores can be used to electronically file GST returns, with automatic settlement of the accounts through financial institutions. In the coming years, these technologies will be used to reduce costs and improve competitiveness.

There are both savings and operational benefits to be obtained from closer administrative collaboration among the smaller agencies located in the National Capital Region. The President of the Treasury Board will undertake a review of accommodation and other services provided to small agencies, working in collaboration with agency heads and their governing boards. This review is not intended to hamper in any way the effective functioning of those agencies or to restrict their varying degrees of independence from government. Rather, it is intended to help the agencies themselves to find efficiencies that will enable them to get the maximum benefit from available resources during a period of severe restraint.

By April 1, 1993, all departments and agencies will move to Operating Budgets that will include salary, operating and minor capital expenditures. This will give managers the flexibility they need to operate effectively within budgets that continue to be severely restrained. It will also allow clearer accountability for results, as well as greater efficiency in the utilization of financial and human resources.

Tackling the regulatory burden

The government is beginning a department-by-department review of existing regulations to ensure that the use of the government's regulatory powers results in the greatest prosperity for Canadians. In this context, departments will be instructed to review their existing regulations to ascertain whether they comply with this objective. This is a major undertaking, and it will have to proceed in stages. Agriculture Canada, Transport Canada and Consumer and Corporate Affairs will be the first departments to engage in this review.

Part of this review should require a public "rejustification" of existing regulations that are to be retained to ensure that those which stifle the creativity and efficiency required by Canadian business to compete and grow in today's modern world or which serve no public good, are removed.

Therefore, the government will ask the Standing Committee on Finance to review the existing federal regulatory programs to:

- determine how they affect our competitiveness; and
- suggest ways to improve regulatory programs, processes and intergovernmental collaboration.

The government will request that the Committee report back to the House by September 30, 1992.

THE EXPENDITURE PLAN TO 1993-94

Table 3.10 sets out the details of budgetary expenditures to 1993-94 by type of payment.

Table 3.10

Budgetary expenditures

	1991-92	1992-93	1993-94
		(millions of dollars)	
A. Major transfers to persons of which:	41,000	42,350	41,275
Old age security	18,450	19,500	20,325
Unemployment insurance benefits	18,150	18,975	19,250
Family allowances[1]	2,800	2,175	
B. Major transfers to other levels of government of which:	24,050	24,150	24,550
Established Programs Financing[2]	8,850	8,085	7,350
Canada Assistance Plan	5,900	6,285	6,575
Equalization and other transfers	9,300	9,800	10,600
C. Major subsidies/other transfers of which:	12,300	13,550	12,950
Transfers to business	2,600	3,000	3,075
Other transfers	9,675	10,550	9,900
D. Payments to major Crown corporations	4,600	4,850	4,900
E. Defence	12,150	12,300	12,700
F. International assistance	2,750	2,825	2,925
G. Reserves net of lapse		1,400	1,850
H. Government operations	17,150	17,975	18,700
I. Program spending	114,000	119,400	119,850
J. Public debt charges	41,500	40,200	41,450
K. Total budgetary expenditures	155,500	159,600	161,300
		(per cent change from previous year)	
A. Total budgetary expenditures	3.7	2.6	1.1
B. Public debt charges	-2.4	-3.1	3.1
C. Program spending	6.1	4.7	0.4
D. Consumer price index (calendar year)	5.6	2.2	2.6

[1] Family allowances will be merged into a new child tax benefit, which is netted against personal income tax collections. The new child tax benefit will provide an increase in benefits over the current system (including family allowances) of $2.1 billion over the next five years. Enrichment of the child care expense deduction will provide an additional $135 million of assistance to families over this period.

[2] EPF to other levels of government are made as a combination of cash and a transfer of tax points. Program spending includes only the cash transfer component as well as adjustments to program spending for prior years.

Total transfers, including cash and tax transfers but excluding prior-year adjustments, are as follows:

	1991-92	1992-93	1993-94
		(millions of dollars)	
Cash and tax transfers to other levels of government	37.0	38.9	40.2

Total budgetary expenditures are expected to increase by 2.6 per cent in 1992-93, down from the increase of 3.7 per cent expected for 1991-92. The lower rate of growth in 1992-93 reflects the impact of lower interest rates on public debt charges, and the impact of the expenditure measures announced in this and previous budgets. Total budgetary expenditures are forecast to increase by 1.1 per cent in 1993-94 – the decrease in the rate of growth is in large part due to the replacement of the monthly payments related to the federal family allowance program by the new child tax benefit which is netted against budgetary revenues.

Public debt charges will decline by 2.4 per cent in 1991-92 and are forecast to decline again in 1992-93. The declines in these two fiscal years reflect the impact of lower interest rates which have accompanied the recent reduction in inflation. As of mid-February 1992, short-term interest rates had declined by 270 basis points since the February 1991 budget and 700 basis points since their peak in May 1990. Long-term interest rates have declined by 100 basis points since the February 1991 budget. On a rule-of-thumb basis, a sustained 100 basis points decline in interest rates (across the maturity spectrum) lowers the federal deficit by $1.8 billion in the first full fiscal year and by $3.0 billion by the third full fiscal year.

Program spending is forecast to increase by 4.7 per cent in 1992-93, down from 6.1 per cent growth expected in 1991-92. The high program spending growth in 1991-92 was due to a number of factors: a surge in unemployment insurance payments as a result of the 1990-1991 recession, higher grain support payments due to depressed world grain markets, and higher Established Programs Financing payments due to prior-year adjustments. During the course of 1991-92, the government undertook a number of restraint measures, including a year-end freeze on discretionary non-wage operating and capital spending, using budgeted reserves to reduce fiscal pressures and the reprofiling of planned expenditures to outer years. In addition, the government has introduced legislation to put its employees' pension plans on a fully funded basis and this is reflected in the revised deficit forecast for 1991-92 and beyond.

The growth in program spending in both 1992-93 and 1993-94 primarily reflects the ongoing impact of the Expenditure Control Plan. The Expenditure Control Plan continues to exempt most of the programs included in major transfers to persons. Developments in this component primarily reflect economic events and increases in the eligible population. However, the growth in this component has been affected in this budget through the restructuring of the child benefit system. Effective January 1, 1993, the monthly family allowance benefit is to be replaced by a monthly child tax benefit delivered through the personal income tax system and netted against personal income tax collections. This has the effect of lowering program spending by about $750 million in 1992-93 and by about $3 billion per year thereafter.

Within major transfers to other levels of government, the Expenditure Control Plan holds per capita Established Programs Financing entitlements constant at the 1989-90 levels. These entitlements are paid in the form of tax point transfers and cash and as the value of the tax point transfer is unaffected by this measure, this restraint initiative impacts entirely on cash transfers. The Expenditure Control Plan also limits the increase in Canada Assistance Plan entitlements to non-equalization receiving provinces (Ontario, Alberta, and British Columbia) to 5 per cent per year. Equalization transfers to the lower-income provinces, as well as Canada Assistance Plan transfers to equalization-receiving provinces, are exempt from the Expenditure Control Plan.

Other major subsidies and other transfers primarily consist of grants and contributions under the various agricultural stabilization programs, transfers to Indians and Inuit, funds for job training, interest subsidies for student loans, as well as various subsidies to support science and technology and industrial and regional development. In total, payments in this component amount to about $13 billion, of which about half is related to supporting agricultural and Indian and Inuit programs.

For the 1991 crop year, the government introduced a new agricultural income support program, developed in consultation with provincial governments and the agricultural community. This program, which consists of the Gross Revenue Insurance Program (GRIP) and the Net Income Stabilization Account (NISA), replaced grain income support previously delivered through the Western Grain Stabilization Account and the Agricultural Stabilization Account programs. The new program is designed to be self-financing over time. In addition, the government has provided additional support in both the 1991-92 and 1992-93 fiscal years to grain farmers. For 1991-92, this support was financed by reallocating resources set aside, but not needed, for the Gulf War. The 1992-93 payments will be sourced from measures to increase the collection of tax receivables as previously announced.

In the February 1991 budget, funding for all science and technology grants and contribution programs was limited to annual increases of 3 per cent, beginning in 1992-93.

Payments to major Crown corporations are expected to amount to $4.6 billion in 1991-92, and remain at about that level for the next two years. The growth in subsidies to the Canadian Broadcasting Corporation has been cut back and the Canada Post Corporation and VIA Rail have been put on a more commercial basis. Canada Mortgage and Housing Corporation's social housing program will be constrained to an annual average growth of 3 per cent for 1992-93 to 1996-97.

With the cuts in the budget, defence will show very little growth in 1992-93 followed by growth of just over 3 per cent in 1993-94. International assistance spending, including ODA cash and other international assistance, principally for Eastern Europe, will grow at 3 per cent per year.

The President of the Treasury Board has introduced a Bill into the House of Commons to bring federal pension legislation into compliance with the *Income Tax Act* and address some long-standing fairness issues having to do with federal pensions. One of these changes proposes to put the public service pension plans on a fully funded basis, consistent with private sector funds. The government currently incurs expenditures to cover indexing costs to the extent that a pensioner's own credits in the indexing pension account have been exhausted. These payments currently amount to over $1 billion a year. Such payments by the government directly impact on program spending and the budgetary deficit.

With the passage of this Bill, existing and future benefits would be fully funded as they are earned, including the indexation costs. Under this Bill, there would be no change in employee contribution rates or in benefits paid. As the government would no longer be making separate payments to cover shortfalls in indexation costs, total budgetary expenditures would be lower by about $1 billion per year. With the pension accounts responsible for the payment of all benefits, the net source of funds in non-budgetary transactions would be correspondingly lower, with the result that financial requirements would be relatively unaffected.

In the 1989-90 Public Accounts, the government established an allowance for the actuarial deficiency of the indexed portion of the government's employees' pension accounts. The value of this allowance was reduced in the 1990-91 Public Accounts, reflecting the improved outlook for inflation and lower wage settlements. The difference in the allowance resulting from changes in economic assumptions is to be spread over 13 years. This results in a reduction in program spending of about $500 million per year.

The measures in this budget include cuts in non-salary, non-capital operating budgets of departments and agencies by 3 per cent, tighter restrictions on travel for Parliamentarians and public servants, reduced communications budgets by $75 million, and elimination or consolidation of a large number of agencies and commissions. This will ensure that the operating costs of government will continue to be restrained.

The fiscal plan represents an attempt to allocate scarce resources among known spending needs. It is of course not possible to predict with great precision how spending needs will evolve and for this reason a certain amount of reserves are set aside for pressures. In the environment of an ongoing need for fiscal restraint, difficult decisions must be made about how to address spending pressures. For most cases, spending pressures will not be able to be met.

In order to remain within the parameters of the fiscal framework of the budget, the government is prepared to act, where necessary, to counter the serious fiscal effects that may arise from legal challenges to government programs. Examples of areas where such action may be required are current challenges with respect to the Spouse's Allowance Program and equal pay for work of equal value. With respect to the Spouse's Allowance Program, the cases have not yet been considered by the Courts. But a judgment that would require the government to spend substantial amounts of money to broaden the program would, in the current fiscal circumstances, require a serious reconsideration of the program itself.

This government is committed to the principle of equal pay for work of equal value in the federal public service. This commitment has been demonstrated both by past equalization payments made by the government – over $467 million to date – and ongoing payments of $81 million annually. The government has taken action to implement the principle of equal pay for work of equal value and it believes that it is currently meeting its obligations in regard to equal pay for work of equal value.

Parties have nevertheless complained to the Canadian Human Rights Commission and are demanding further adjustments. The Commission has referred the matter to a Human Rights Tribunal and hearings are under way.

In light of the uncertainty associated with these complaints and taking into account the need to control government spending, the government has concluded that it is necessary to limit its potential liability in relation to past years. The government will therefore not make any further payments in respect of the period before November 1, 1990, the date on which the complaints were referred to the Human Rights Tribunal. The government is prepared to take legislative action to give effect to this decision. For the future, the government is undertaking a major reform of the job classification system to design and implement a universal job-evaluation plan. This will provide a durable basis for maintaining equal pay for work of equal value. This reform is fundamental to finding a permanent solution to the issue.

THE SPENDING CONTROL ACT

In the February 1991 budget, the government announced its intention to introduce legislated limits on total program spending. Legislated spending limits would ensure that the program spending over the 1991-92 to 1995-96 period could not, except in a limited set of prescribed circumstances, exceed the projections in the 1991 budget. The *Spending Control Act* pulls together a variety of spending control mechanisms introduced as part of the Expenditure Control Plan under an umbrella that makes spending control more visible, easier for the public to understand and fills some important gaps left by current mechanisms. For example, if expenditure on a program rose above the projection for economic or policy reasons, it would have to be offset by reductions elsewhere – the proposed legislation would not allow increased borrowing or increased taxes to fund higher-than-expected projected spending.

On July 12, 1991, the government submitted the draft *Spending Control Act* to the Standing Committee on Finance for review. The Committee heard from a variety of witnesses. The Committee released its report on November 25, 1991, and made nine recommendations. As a result, a number of changes to the draft Act have been incorporated into the final legislation, which was presented to Parliament on February 14, 1992. The major changes are:

- Only the major self-financing programs – *Unemployment Insurance Act*, the Agricultural Commodities Stabilization Accounts, the Gross Revenue Insurance Plan and the Crop Re-insurance Fund – will be exempt from the spending control limits; all other self-financing programs will now be included in the spending control limits. In addition, in order to considerably simplify the Act, the spending control limits will explicitly exclude all spending on the four major self-financing programs (this does not alter the operation of the controls vis-à-vis the draft proposal).
- The Act specifies that any overspending must be recovered within the two fiscal years immediately following the fiscal year in which the overspending occurred.
- The Minister of Finance will be required to present a recommendation to Parliament in the 1994 budget with respect to the status of the Act after 1995-96. The 1994 and 1995 budgets must address how any overspending over the period 1991-92 and 1995-96 control period must be made up in the following two years.
- The Auditor General will express an opinion as to the compliance to the Act.

The program spending projections in this budget for the period 1991-92 to 1995-96 are shown in Tables 3.10 and 3.14. In order to determine whether these projections are consistent with the proposed Spending Control Limits, adjustments for the four self-financing programs, as well as any other adjustments permitted under the *Spending Control Act* must be made. Program spending subject to the proposed Spending Control Limits are indicated in Table 3.11. As a result of the spending restraint measures in this budget, the controlled program spending projections for the period 1991-92 to 1995-96 are below the spending control limits set out in the proposed *Spending Control Act* and, therefore, are in compliance with the proposed *Spending Control Act*. When legislation with respect to full funding of federal pensions and the restructuring of the child benefit system has been approved by Parliament, the government will propose amendments to the *Spending Control Act* to bring controlled program spending limits into conformity with these changes.

Table 3.11

February 1992 budget
Compliance with the *Spending Control Act*

	1991-92	1992-93	1993-94	1994-95	1995-96
	(millions of dollars)				
A. *Spending Control Act*					
1. February 1991 budget limits	115,800	119,650	122,800	126,450	130,600
2. Less self-financing programs	-18,600	-18,750	-18,740	-19,050	-19,350
3. Spending limits[1]	97,200	100,900	104,100	107,400	111,250
B. February 1992 budget					
1. Program spending	114,000	119,400	119,850	124,100	128,050
2. Adjustments					
Unemployment Insurance					
Benefits	-18,150	-18,975	-19,250	-19,525	-19,650
Administration	-1,252	-1,322	-1,350	-1,360	-1,360
GRIP advances	-132	-41			
Total adjustments	-19,534	-20,338	-20,600	-20,885	-21,010
3. Program spending subject to the *Spending Control Act*	94,466	99,062	99,250	103,215	107,040

[1] Spending limits in the Proposed *Spending Control Act*.

THE REVENUE OUTLOOK TO 1993-94

The projections presented in Table 3.12 provide an overview of the revenue outlook to 1993-94. They are based on the economic outlook presented in Chapter 2 and incorporate the impact of the fiscal measures announced in this budget.

The key influences for the revenue outcome for 1991-92 are the impact of the recession and the transitional costs associated with sales tax reform. The recession has dampened the personal and corporate tax bases, resulting in substantially lower revenues than forecast in the February 1991 budget. With the expected improvement in the economy in the second half of 1992, the tax bases should improve. However, overall revenue growth will be affected in both 1992-93 and 1993-94 by the impact of the new child tax benefit.

Throughout most of 1991-92, the growth in personal income tax collections has been extremely weak, reflecting the sluggishness in the growth in personal income. The replacement of the sales tax credit (which was paid at the time of tax filing and netted against personal income tax collections) by the low-income Goods and Services Tax (GST) Credit (which is paid quarterly and netted against GST revenues) will result in higher net collections in the final quarter of 1991-92. Recoveries for overpayments to provinces under the Provincial Tax Collection Agreements will also result in higher reported collections in the final quarter of 1991-92. Personal income tax collections in both 1992-93 and 1993-94 will be affected by the netting of the monthly child tax benefit and the reduction in the personal income surtax.

Table 3.12

Budgetary revenues

	1991-92	1992-93	1993-94
		(millions of dollars)	
Personal income tax	61,500	63,050	64,450
Corporate income tax	8,400	9,500	11,780
Unemployment insurance contributions	16,000	19,050	20,700
Sales and excise taxes/duties	10,500	11,775	11,900
Goods and Services Tax	16,400	18,600	20,150
Other revenues	11,300	10,125	9,820
Budgetary revenues	124,100	132,100	138,800
	(percentage change from previous year)		
Personal income tax	6.8	2.5	2.2
Corporate income tax	-28.4	13.1	24.0
Unemployment insurance contributions	25.8	19.1	8.7
Sales and excise taxes/duties	-55.4	12.1	1.1
Goods and Services Tax	–	13.4	8.3
Other revenues	1.1	-10.4	-3.0
Budgetary revenues	4.0	6.4	5.1

The recession has had a pronounced effect on corporate profits. Rising unit labour costs and weakening demand have left corporate profit margins at their lowest levels since the 1981-1982 recession. Corporate profits declined by over 25 per cent in 1991. Although corporate profits are expected to improve significantly over the next two years, the impact on corporate income tax collections will be moderated due to the loss carry-forward provisions in the corporate income tax system. In addition, measures introduced in this budget to enhance competitiveness will affect the flow of revenues.

To ensure the financial integrity of the Unemployment Insurance Account, premium rates were increased effective July 1, 1991 and again on January 1, 1992. It is assumed for the purposes of the budget fiscal projections that the rates for 1993 remain at their current levels.

The main components in the category federal sales and excise taxes and duties are customs import duties, motive fuel excise taxes, and excise levies on tobacco and alcohol products. The large decline in this component in 1991-92 reflects the replacement of the federal manufacturers' sales tax by the Goods and Services Tax on January 1, 1991, coupled with the refunding of the manufacturers' sales tax paid on inventories. The increase in 1992-93 also reflects the refunding in 1991-92 of the manufacturers' sales tax paid on inventories.

The GST became effective January 1, 1991. The level of GST revenues in 1991-92 was dampened by the one-time transitional grant paid to small business. This grant also affects the growth rate of GST revenues between 1991-92 and 1992-93. Excluding this grant, the

growth in GST revenues reflects the anticipated increase in the GST tax base in 1992-93 and beyond.

GST REVENUES IN 1991-92

The February 1991 budget forecast net revenues from the GST of $16.4 billion. Although personal and corporate income tax collections for 1991-92 are significantly below the levels forecast in the February 1991 budget, reflecting weaker-than-expected economic growth, GST collections remain on track.

Part of the current weakness in economic activity stems from lower-than-expected business investment and exports which are not subject to the GST. While some components of the GST base are lower-than-expected in the February 1991 budget, others, such as expenditures on residential construction, are higher. As a result, the aggregate GST tax base for 1991-92 is little changed from that forecast in the February 1991 budget and hence the net collections for 1991-92 are very similar.

Other revenues consist of non-resident taxes, other tax revenue and non-tax revenues. Developments in these components are quite volatile, reflecting international developments, asset sales, and interest rate changes.

DEBT SERVICING AND REDUCTION ACCOUNT

The government has introduced legislation to establish a special purpose account, to which will be credited net revenues from the GST, gifts to the Crown earmarked to debt reduction, and the proceeds from privatization. These revenues are to be used only to service the public debt. Table 3.13 sets out the flows in the Account.

Table 3.13

Debt Servicing and Reduction Account

	1991-92	1992-93	1993-94
	(millions of dollars)		
Net GST revenues/ privatization/private remittance	16,400	18,600	20,150
Public debt charges	-41,250	-40,200	-41,450
Total	-24,850	-21,600	-21,300

The Debt Servicing and Reduction Account, in conjunction with the legislated spending caps provides assurance that GST revenues will go to deficit and debt reduction, and not fund new program spending.

THE FISCAL OUTLOOK: 1992-93 TO 1996-97

Table 3.14 summarizes the fiscal outlook to 1996-97. These projections are based on the economic assumptions described in Chapter 2 and reflect the impacts of the proposed

Table 3.14

Summary statement of transactions: Budget 1992

	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
			(millions of dollars)			
Budgetary transactions						
Budgetary revenues	124,100	132,100	138,800	151,200	161,300	167,800
Program spending	-114,000	-119,400	-119,850	-124,100	-128,050	-132,000
Operating balance	10,100	12,700	18,950	27,100	33,250	35,800
Public debt charges	-41,500	-40,200	-41,450	-41,600	-41,750	-41,300
Budgetary deficit	-31,400	-27,500	-22,500	-14,500	-8,500	-5,500
Non-budgetary transactions						
Loans, investments and advances	200	400	500	300	300	300
Specified Purpose Accounts	4,500	7,200	7,800	8,300	8,800	9,400
Other transactions	-800	200	900	1,200	1,000	1,000
Net source of funds	3,900	7,800	9,200	9,800	10,100	10,700
Financial requirements (excluding foreign exchange)	-27,500	-19,700	-13,300	-4,700	1,600	5,200
Net public debt (billions of dollars)	419.8	447.3	469.8	484.3	492.8	498.3
Gross domestic product (billions of dollars)	683.4	713.6	769.2	828.3	887.2	945.6
			(percentage of GDP)			
Budgetary revenues	18.2	18.5	18.0	18.1	18.1	17.6
Program spending	-16.7	-16.7	-15.5	-14.9	-14.3	-13.9
Operating balance	1.5	1.8	2.5	3.3	3.7	3.8
Public debt charges	-6.1	-5.6	-5.4	-5.0	-4.7	-4.3
Budgetary expenditures	-22.8	-22.3	-20.9	-19.9	-19.0	-18.2
Deficit	-4.6	-3.8	-2.9	-1.7	-1.0	-0.6
Financial requirements	-4.0	-2.8	-1.7	-0.6	0.2	0.5
Net public debt	61.5	62.6	60.9	58.1	55.2	52.4

Note:

(-) indicates a net requirement for funds.
(+) indicates a source of funds.

Expenditure Control Plan and other policy actions, announced in this budget or previously.

Deficit for 1991-92 at $31.4 billion

In the first nine months of 1991-92, the deficit was $26.8 billion. In order to meet the deficit target of $31.4 billion, the deficit over the remaining quarter of 1991-92 and the supplementary period must increase by $4.6 billion, which is significantly less than the increase in the deficit recorded in the corresponding period of 1990-91. The reasons for the relative improvement in the deficit in the final quarter of 1991-92 vis-à-vis last year are:

- the ending of the GST transitional costs;
- the impact of the decline in interest rates on public debt charges;
- the impact of the February 1990 and 1991 budget measures, along with actions taken throughout 1991-92 to control the buildup in the deficit; and

- the impact of the proposed pension legislation to put public service pension plans on a fully funded basis.

Deficit improves over outlook period

The deficit declines $4 billion in 1992-93 to $27.5 billion and by a further $5 billion to $22.5 billion in 1993-94. This reflects the impact of the measures introduced in this and previous budgets, coupled with the lower interest rates and economic recovery.

As a proportion of GDP, the deficit declines from 4.6 per cent in 1991-92 to 3.8 per cent in 1992-93 and to 2.9 per cent in 1993-94. By 1996-97, the deficit-GDP ratio is well below 1 per cent (See Charts 3.1 and 3.6).

Zero financial requirements by 1995-96

Financial requirements, excluding foreign exchange requirements – a comprehensive measure of the government's borrowing in credit markets – fall from $27.5 billion in 1991-92 to just under $20 billion in 1992-93 and $13 billion in 1993-94. Zero financial requirements will be met in 1995-96, one year later than projected in the February 1991 budget (see Chart 3.7).

Program spending remains strictly controlled

As a percentage of GDP, program spending declines from 16.7 per cent in 1992-93 to 15.5 per cent in 1993-94 and to under 14 per cent in 1996-97 (see Chart 3.8).

Program spending increases by 6.1 per cent in 1991-92, due primarily to increased unemployment insurance benefit payments. Over the period, 1992-93 to 1996-97, the annual average rate of growth is 3 per cent.

The level of program spending subject to control under the proposed *Spending Control Act* is below the spending limits set by the proposed *Spending Control Act*.

Revenue share to GDP stable

Budgetary revenues, as a proportion of GDP, stabilize at about 18 per cent, as the impact of the new child tax credit on personal income tax revenue and the reduction in the personal income surtax offsets the effect of the strength in the tax bases on overall budgetary revenues. Public debt charges as a proportion of government revenues decline from a peak of just under 36 cents in 1990-91 to 30 cents in 1992-93 and decline continually thereafter (see Chart 3.9).

Public debt as a proportion of the economy declines

As a proportion of GDP, public debt peaks at 62.6 per cent in 1992-93 and declines thereafter. The ratios throughout the period, however, are higher than forecast in the February 1991 budget, primarily reflecting lower levels of nominal income (see Chart 3.10).

Reconciliation with the February 1991 budget

Changes to the deficit since the February 1991 budget are provided in Table 3.15. In 1991-92, the deficit is expected to be $31.4 billion, up $0.9 billion from the February 1991 budget estimate of $30.5 billion. In 1992-93, the forecast deficit, at $27.5 billion, is expected to be $3.5 billion higher than in the February 1991 budget.

Chart 3.6
Budgetary revenues and budgetary expenditures 1970-71 to 1996-97

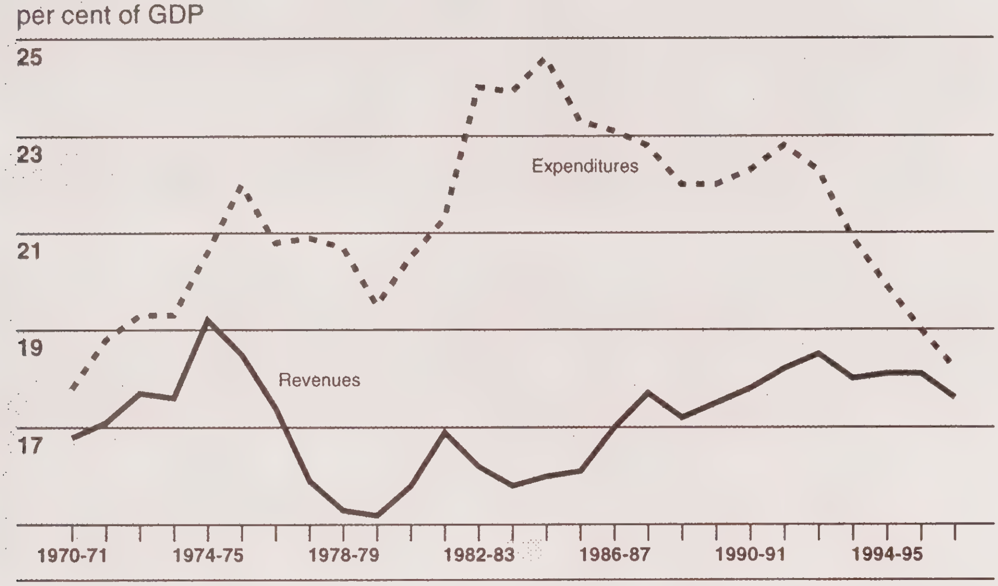


Chart 3.7
Borrowing requirements

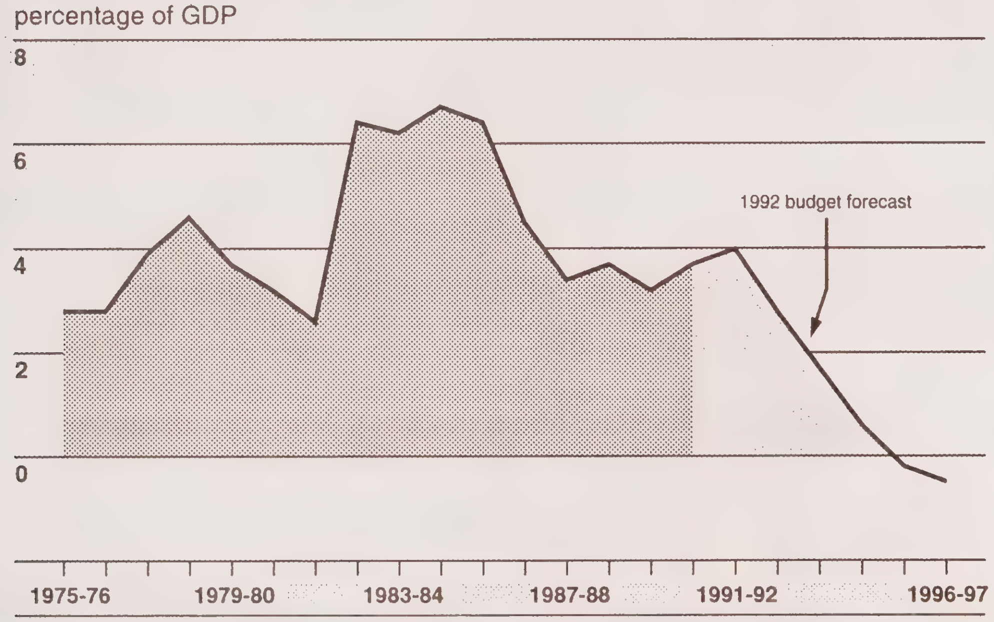


Chart 3.8
Program expenditures 1980-81 to 1996-97

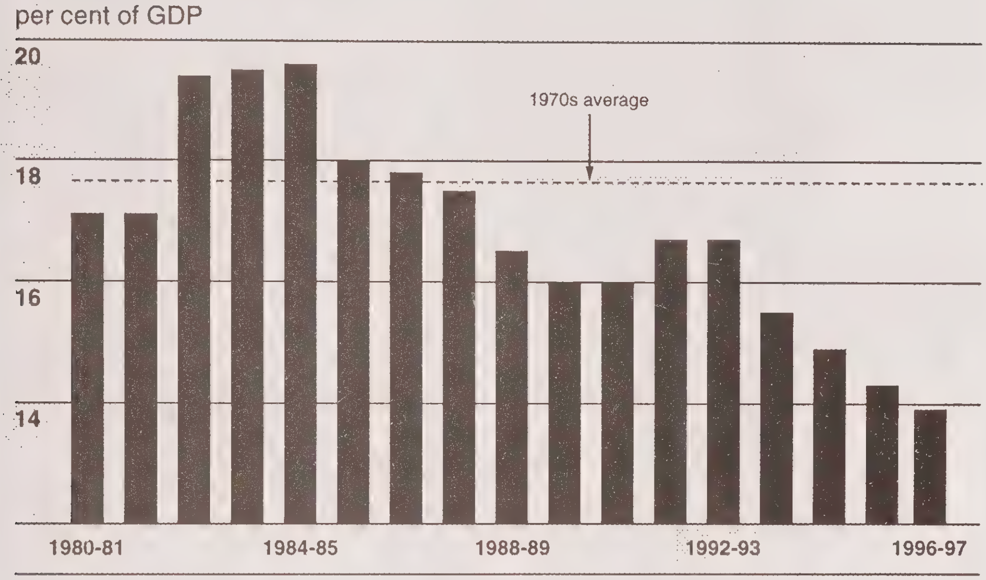
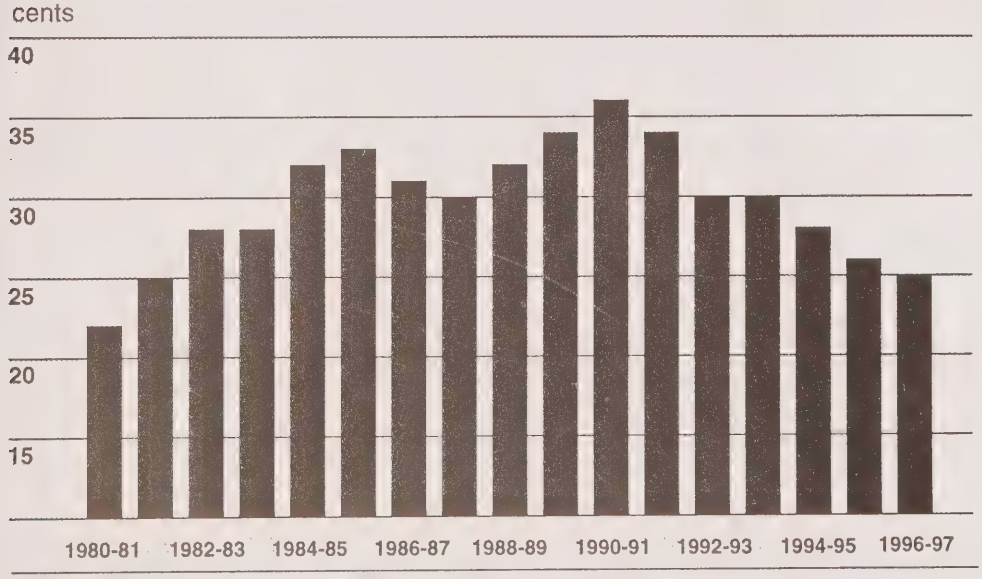


Chart 3.9
Debt charges per dollar of revenue



The slow economic growth among Canada's major trading partners has resulted in weaker-than-expected growth in Canada as well. This, in turn, has impacted adversely on the various tax bases, resulting in lower tax collections and higher unemployment insurance benefits. Transfers to provinces are also higher, primarily reflecting higher cash transfers under Established Programs Financing, due to the slower growth in the value of tax point transfers.

The impacts of lower interest rates on public debt charges and various policy actions offset most of the deterioration in the deficit outlook resulting from changes in the economic environment in 1991-92, although less than in 1992-93. Short-term interest rates in 1991 were about 60 basis points lower on average than forecast in the February 1991 budget. For 1992, they are forecast to be about 200 basis points lower. As a result, public debt charges are substantially lower in both 1991-92 and 1992-93 than forecast in the February 1991 budget.

The government has undertaken a number of actions to offset the impact of the lower-than-expected economic growth on the deficit. To maintain the financial integrity of the Unemployment Insurance Account, the government increased unemployment insurance premiums, effective January 1, 1992, from $2.80 per $100 of maximum insurable earnings to $3.00 (employee contribution rate). In addition, for 1991-92, a number of internal expenditure control measures were put in place, including the year-end freeze on discretionary non-wage operating and capital spending, using budgeted reserves to offset fiscal pressures, and the reprofiling of grants and contributions. For 1992-93, the government extended and broadened the Expenditure Control Plan. The government has also introduced legislation which will put its employees' pension plans on a fully-funded basis. Downward revisions were also made to the actuarial liability for employee pensions in 1990-91 and these adjustments are spread over 13 years.

In 1992-93, the deficit is $3.5 billion higher than forecast in the February 1991 budget. This deterioration is attributable to the impact of the weaker economic growth on the tax bases and unemployment insurance benefit payments. A significant portion of this deterioration is offset by the effects of lower interest rates on public debt charges, the increase in unemployment insurance premiums, and the pension adjustments. The measures introduced in this budget to enhance competitiveness, to increase direct support to working families with children, and the reduction in the general personal income surtax were largely offset by the Expenditure Control actions announced in this budget.

Table 3.15

Change to the deficit since the February 1991 budget

	1991-92	1992-93
	(billions of dollars)	
February 1991 budget deficit	30.5	24.0
Changes due to economic factors		
Personal income tax	2.7	4.7
Corporate income tax	2.6	2.6
Other revenues	-0.6	0.2
Unemployment insurance benefits	1.0	1.9
Major transfers to provinces	0.9	0.6
Other program spending	-1.1	-0.1
Net impact on operating balance	5.4	9.9
Public debt charges	-1.7	-3.8
Changes due to policy actions[1]		
Unemployment insurance premiums	-0.3	-1.1
Extension of Expenditure Control Plan		-1.1
Year-end freeze/other internal actions	-1.0	–
Family benefit package	–	0.5
Measures to enhance competitiveness	–	0.1
Reduction in personal income surtax	–	0.5
Other tax measures	–	-0.1
Full-funding of pensions	-1.0	-1.0
Amortization of pension liability	-0.5	-0.5
Net impact	-2.8	-2.6
Total changes	0.9	3.5
February 1992 budget deficit	31.4	27.5

Note:

(-) indicates a decrease in the deficit.
(+) indicates an increase in the deficit.

[1] Deficit impacts are based on passage of legislation now before Parliament.

Factors affecting financial requirements

The government's net financial requirements consist of non-budgetary, as well as budgetary transactions. These include loans, investments and advances, government employees' pension accounts, other specified-purpose accounts, interest and debt accounts, and other non-budgetary transactions. Total non-budgetary transactions have normally provided the government with a net source of funds, lessening its dependence on financial markets. Table 3.16 sets out the projection for non-budgetary transactions to 1992-93.

The principle underlying the distinction between budgetary and non-budgetary transactions is that transactions changing the net indebtedness of the government are classified as budgetary, and those involving the receipt of offsetting financial assets or the creation of liabilities are classified as non-budgetary. In addition, the government maintains a number of trust accounts that are held for third parties, such as pension

accounts of federal government employees. Other non-budgetary transactions include accounting adjustments to certain budgetary transactions that are recorded on an accrual basis to a cash basis. These include interest accounts, accounts payable, cash-in-transit, and outstanding cheques.

Table 3.16

Non-budgetary transactions

	1991-92	1992-93	1993-94
		(billions of dollars)	
Loans, investments, and advances	0.2	0.4	0.5
Specified purpose accounts	4.5	7.2	7.8
Other transactions	-0.8	0.2	0.9
Non-budgetary transactions	3.9	7.8	9.2

Note: Figures may not add due to rounding.

Financial requirements and borrowing authority

The amount of borrowing authority requested from Parliament for a fiscal year has traditionally been tied to the financial requirements forecast for that year. The actual level of borrowing is also influenced by foreign exchange transactions that cannot be forecast in advance.

For 1992-93, the government will be seeking borrowing authority in the amount of \$24.7 billion, to cover financial requirements of \$19.7 billion, expected Exchange Fund earnings of \$2.0 billion, and a \$3 billion contingency to manage foreign exchange transactions (Table 3.17). Borrowing authority to cover Exchange Fund earnings is requested because these earnings, although reported as budgetary revenues, remain in the Exchange Fund Account and are not available to finance ongoing operations of government. In addition, the government reached the limit of its borrowing authority for 1991-92 by the end of January 1992. As a result, the government is seeking additional borrowing authority of \$3.9 billion to cover borrowing in fiscal 1991-92 under Section 47 of the *Financial Administration Act*. These borrowings are charged to 1992-93 borrowing authority.

Table 3.17
Borrowing requirements

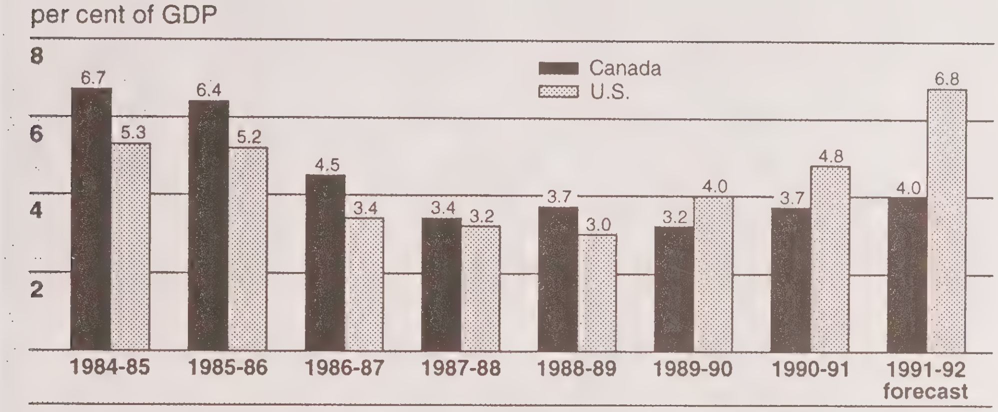
	1992-93
	(billions of dollars)
Financial requirements (excluding foreign exchange requirements)	19.7
Exchange fund earnings	2.0
Reserve for contingencies	3.0
Regular borrowing authority requested	24.7
Additional borrowing authority required to cover use of Section 47 in 1991-92	3.9

ANNEX
CANADA-UNITED STATES FISCAL COMPARISON

OVERVIEW

- The importance of the U.S. economy to Canada, in particular our highly integrated financial markets, requires a particular focus on the fiscal performance of governments in the two countries. This Annex compares the recent fiscal performance of both the federal and other levels of government in the two countries. The levels of taxation are also examined in the context of differing levels of spending on social programs. Lastly, projected developments in federal government fiscal situations are presented.
- On a comparable accounting basis, the Canadian federal government has reduced its deficit substantially relative to GDP from its peak in 1984-85 (Chart A3.1). Moreover, while the recession and its aftermath have caused the Canadian federal deficit to rise slightly in both 1990-91 and 1991-92, it is expected to decline in 1992-93 and be in near balance by mid-decade (Chart A3.10). This fiscal consolidation has been achieved primarily by reining in the growth of spending, thereby reducing the federal government's size in relation to the economy (Chart A3.4).
- In contrast, the U.S. federal deficit relative to GDP has increased significantly over the last three years and is now above its 1984-85 level. It is also substantially above the Canadian federal government deficit on a comparable accounting basis.
- The operating balance of the federal government in Canada is in a substantial surplus and is expected to continue to improve over the coming years (Charts A3.2, A3.11). The operating balance in the United States is in a deficit position at present and is not expected to be in surplus until 1993-94.
- Spending by other levels of government in Canada is higher, relative to the size of the economy, than its U.S. counterpart (Chart A3.5). This difference in spending levels reflects in large part the fact that these levels of government are responsible for the delivery of public health care and public education services, which are much more comprehensive in Canada than in the United States.
- Reflecting higher levels of public services, total taxes by all levels of government are higher in Canada than in the United States (total taxes are equivalent to 35.3 per cent of GDP in Canada versus 30.1 per cent in the United States) (Chart A3.7). However, if the level of U.S. taxation is adjusted to reflect the different levels of public spending on health and education services (Chart A3.6), the difference in relative levels of taxation is reduced to less than 2 percentage points of GDP.

Chart A3.1
Federal government deficits
Fiscal years

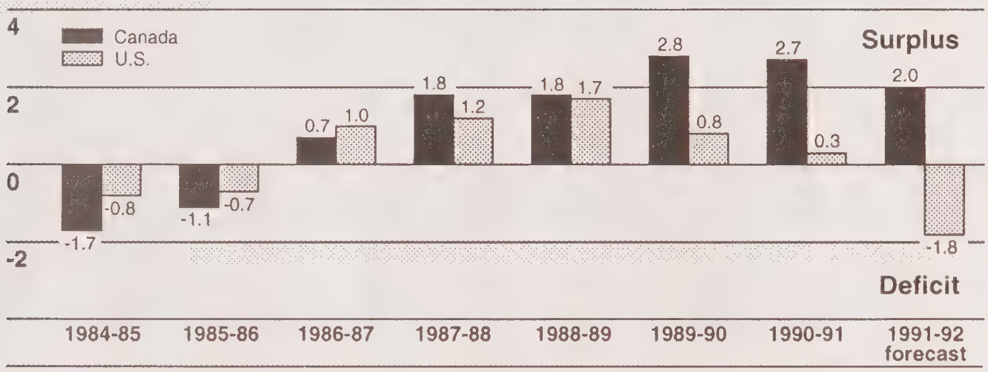


Notes 1: Financial requirements for Canada and Unified Budget Basis (UBB) balance for the United States.
2: Fiscal years ending March 31 and September 30 of the same year for Canada and the U.S., respectively.

Sources: Canada: Department of Finance Canada; United States: U.S. Department of Commerce fiscal year 1993 U.S. Budget.

- The federal deficit in Canada (defined as financial requirements to make it comparable to the U.S. deficit on a Unified Budget Basis) declined significantly over the 1980s – from 6.7 per cent of GDP in 1984-85 to 3.2 per cent in 1989-90. Substantially more progress has been made in Canada than in the United States in reducing its deficit relative to GDP.
- In fact, the deficit in Canada has moved from being above that in the United States until 1988-89, to being substantially below it.
- Reflecting the deterioration in economic conditions, however, the Canadian federal deficit rose slightly over the last two years. Nevertheless, government actions have limited the degree of deterioration of the government's fiscal position. By comparison, the U.S. government's deficit in 1991-92 is expected to be more than double the level recorded in 1988-89.

Chart A3.2
Federal government operating balance
Fiscal years



Notes 1: Financial requirements less gross debt service payments for Canada and Unified Budget Basis (UBB) deficit less gross debt service payments for the United States.
2: Fiscal years ending March 31 and September 30 of the same year for Canada and the U.S. respectively.

Sources: Canada: Department of Finance Canada; United States: U.S. Department of Commerce and fiscal year 1993 U.S. Budget.

- Substantial progress has been made in reducing the operating deficit (the deficit minus gross debt charges) of the federal government in Canada. In fact, the operating balance has moved from a huge deficit in 1984-85 to a substantial surplus.
- In contrast, the improvement in the operating balance in the United States which took place from 1984-85 to 1988-89, has been reversed in the last three years, with the operating deficit returning this year to a level higher than in 1984-85.

Chart A3.3a
PLH and state and local government budget balances[1]

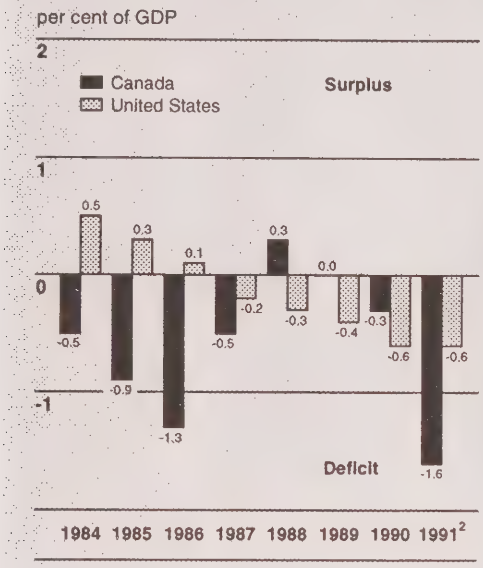
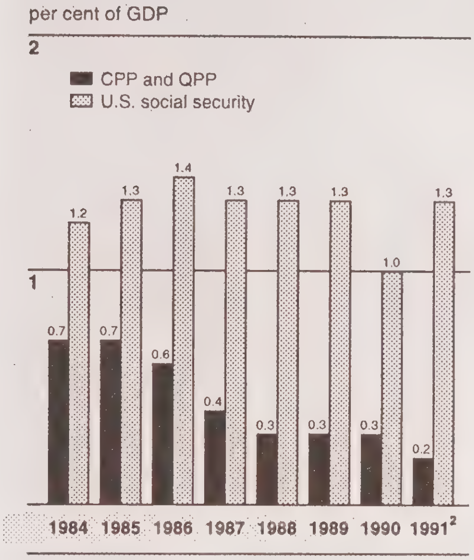


Chart A3.3b
Public pension fund budget balances[1]

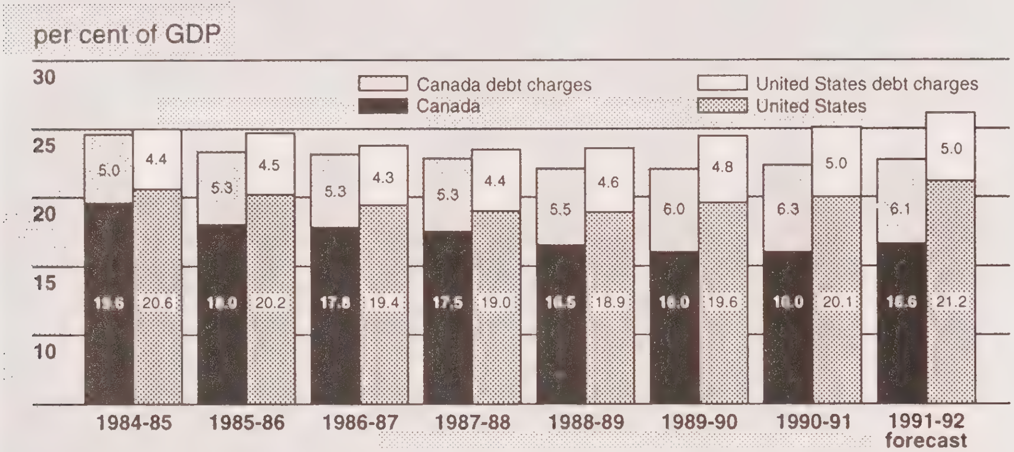


[1] National Accounts basis.
[2] Canadian data for 1991 based on estimates for the fourth quarter.

Sources: Canada: Statistics Canada; United States: U.S. Department of Commerce.

- Through the 1984 to 1991 period, the fiscal performance of the provincial-local-hospital (PLH) sector in Canada has, in general, been worse than the state and local government sector in the United States.
- Budget deficits at the provincial-local-hospital level in Canada improved through 1988, but deteriorated substantially in the last two years. The budget balance of the state and local government sector (excluding social security) has also gone into a sizeable deficit position in recent years.
- Public pension funds in both Canada and the United States have consistently recorded surpluses through the 1980s and early 1990s, although the Canadian surpluses have been much lower than their U.S. counterparts. The budget surplus in this sector in Canada, however, has deteriorated over this period.

Chart A3.4
Federal government program expenditure and debt service
Fiscal years

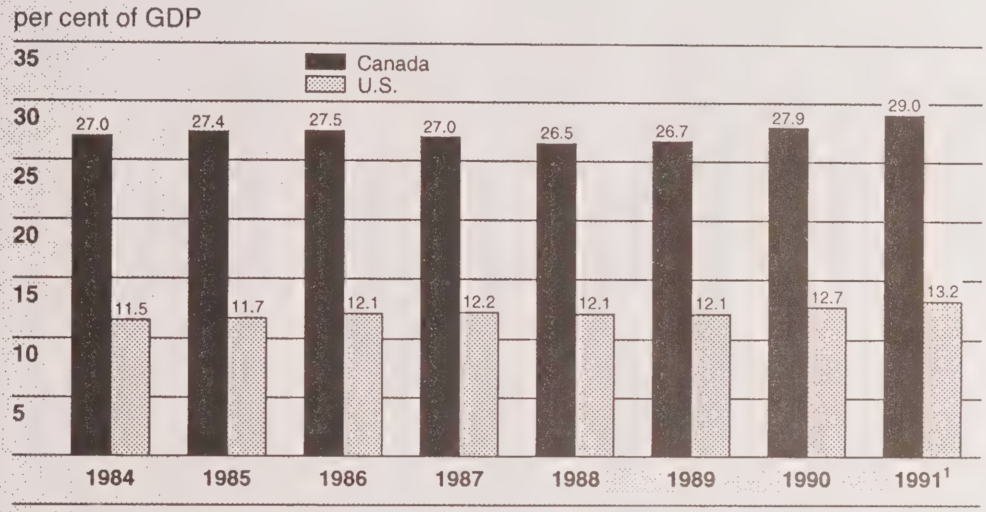


Note: Fiscal years ending March 31 and September 30 of the same year for Canada and the U.S., respectively.

Sources: Department of Finance Canada; United States: U.S. Department of Commerce and fiscal year 1993 U.S. Budget.

- Progress in reducing federal government program spending (i.e. spending excluding debt service charges) in Canada has been more marked than in the United States. Total spending as a per cent of GDP by the federal government in Canada is lower than that in the United States and the difference in spending levels has been widening since 1987-88.
- Federal program spending in Canada is proportionately smaller than its U.S. counterpart. Federal program spending as a share of GDP has fallen substantially in Canada while it has changed little in the United States since the mid-1980s.
- Federal public debt charges as a share of GDP are somewhat higher in Canada, and have risen over the last several years reflecting the rising stocks of debt in Canada and the United States.

Chart A3.5
Non-central government expenditure
National Accounts basis, calendar years



[1] National Accounts basis.

Sources: Canada: Statistics Canada; United States: U.S. Department of Commerce.

- Spending by the provincial-local-hospital sector and the Canada and Quebec Pension Plans (CPP/QPP) in Canada has been substantially above that of the state and local government sector in the United States. In this regard, it is important to note that this sector is responsible for the delivery of much of the public health and education services in Canada while, in contrast, most of these services are delivered by the private sector in the United States.
- Unlike trends at the federal government level, spending by these levels of government has risen in both countries, in relation to the size of the economy, over the 1984 to 1989 period.

Chart A3.6a
Health care spending
Private and public – 1987

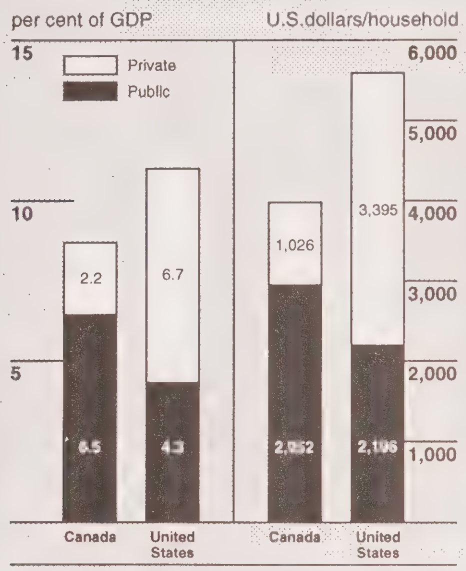
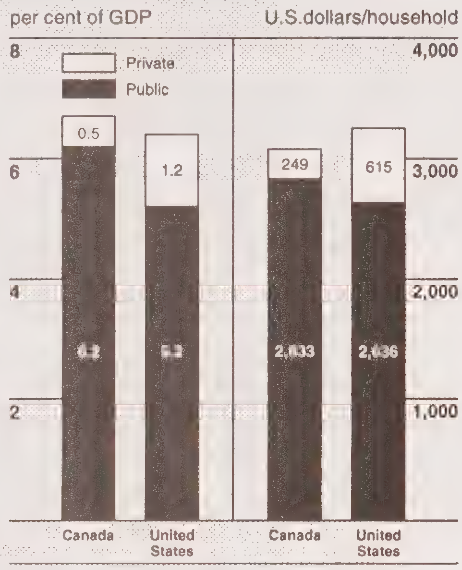


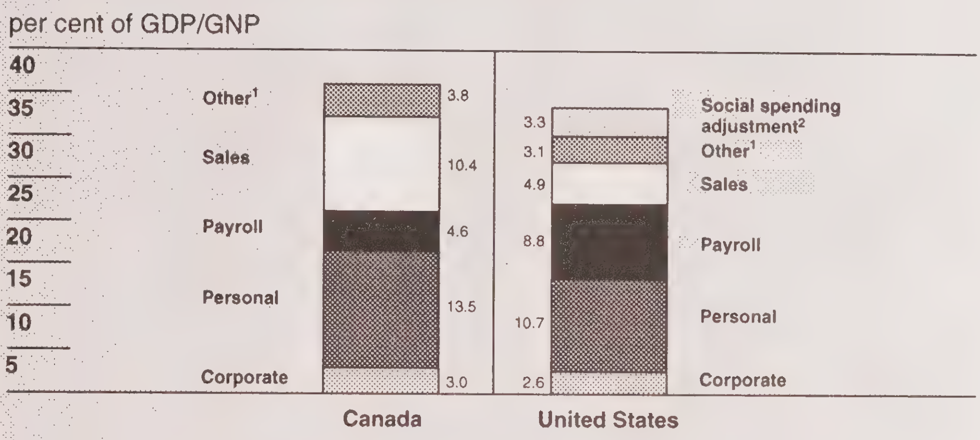
Chart A3.6b
Total education spending
Private and public – 1987



Sources: Canada: Statistics Canada, 1992 Year Book; United States: U.S. Department of Commerce, Statistical Abstract of the United States, 1989.

- Total health care spending by the private and public sectors (including spending on hospital and other institutional services, dental services, prescription drugs, etc.) relative to the size of the economy is larger in the United States than in Canada (11.0 per cent of GDP in the United States versus 8.7 per cent in Canada).
- However, a much larger share of total health care spending in Canada is delivered by the public sector than in the United States. In Canada, governments account for about 75 per cent of total health care spending, while the governments' share is only about 40 per cent in the U.S. Indeed, nearly one in five Americans are not covered by either government or private plans, whereas in Canada health insurance coverage is universal.
- Total spending on all levels of education is very similar (in relative terms) in Canada and the U.S. (approximately 6½ per cent of GDP). The share of government spending on education is somewhat larger in Canada, accounting for about 90 per cent of total spending compared with about 80 per cent in the U.S. On a per household, common-currency (U.S. dollar) basis, however, education spending is slightly higher in the U.S.

Chart A3.7
Taxes by all levels of government in Canada and the United States – 1989



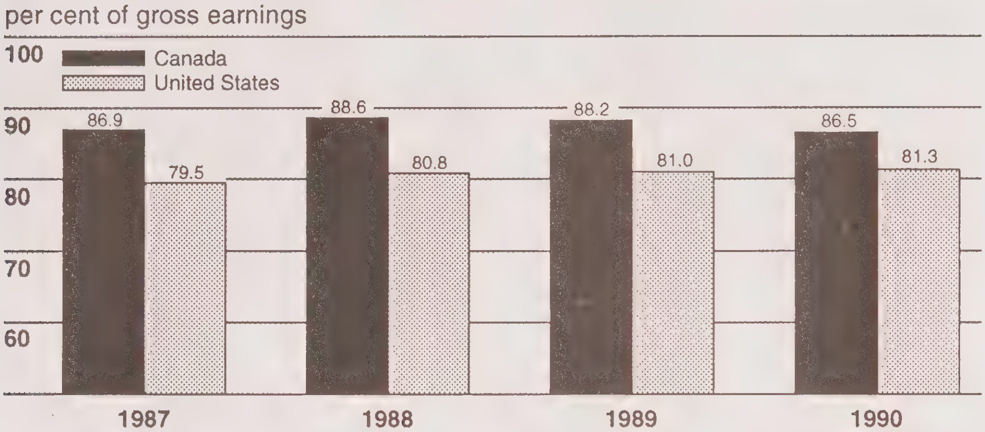
[1] Other taxes include property and miscellaneous taxes.

[2] Adjustment to bring U.S. government health and education spending to Canadian levels as a per cent of national income.

Source: OECD (1991), *Revenue Statistics of OECD Member Countries, 1965-1990.*

- Canadian governments raise revenue from a variety of sources: principally, personal and corporate income taxes, sales taxes and payroll taxes. Canada relies more on income and sales taxes than the U.S., but much less on social security (payroll) taxes.
- Taxes by all levels of government are higher in Canada relative to GDP than in the United States (35.3 per cent versus 30.1 per cent). However, the perception that Canadian income taxes are unduly high is often based on a narrow focus on personal income taxes, and ignores the second largest source of U.S. taxes – payroll taxes. Payroll taxes account for a much larger share of the tax burden in the U.S.: equivalent to about 8.8 per cent of national income in the U.S. compared with 4.6 per cent in Canada. Income taxes, both personal, and corporate, and payroll taxes combined are equivalent to 22.1 per cent of GDP in the United States compared with 21.1 per cent of GDP in Canada.
- However, the higher level of total taxation in Canada largely reflects the higher level of government-provided services, especially health-care spending. Thus, if U.S. tax burdens are adjusted to reflect a level of public-sector health and education spending similar to Canada's (i.e. adjusting the U.S. tax burden by an amount equivalent to the difference in public-sector spending on these programs as a per cent of national income) the difference in relative levels of taxation between Canada and the United States is reduced to less than 2 percentage points of GDP.

Chart A3.8
Take-home pay and cash transfers for average production workers in manufacturing

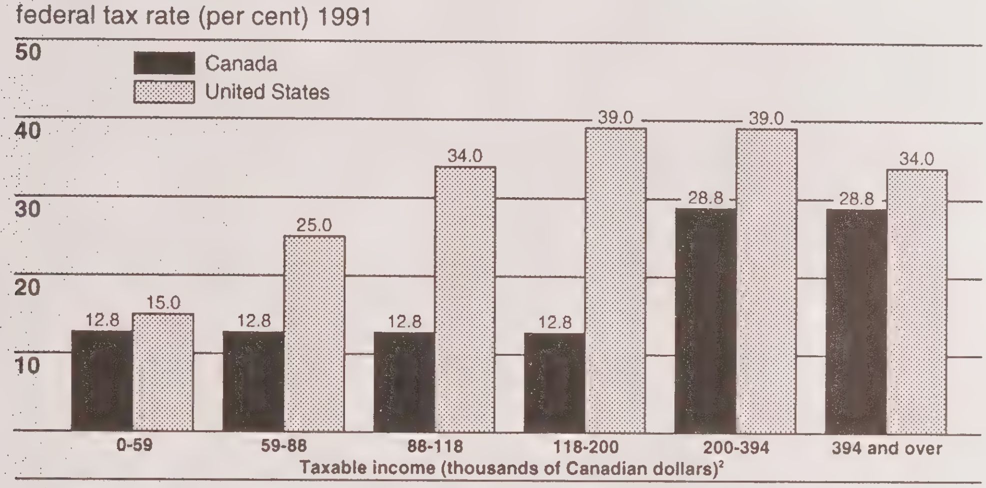


Note: Take-home pay refers to gross earnings minus income tax and employee's social security contributions. The rate of tax used in this calculation assumes standard deductions for a single-income family with two dependent children.

Sources: OECD (1991), The Tax and Benefits Position of Production Workers, 1987-1990.

- According to the OECD, the average Canadian production worker with a family of four takes home a greater percentage of their gross earnings than does a similar worker in the United States when cash transfers from all levels of government are taken into account. (The average Canadian production worker's gross earnings were $28,571 in 1990, about 7 per cent higher than the average U.S. production wage of $26,708 (in Canadian dollars).)
- Over the 1987 to 1990 period, the average production worker's take-home pay (including cash transfers from the government) averaged 87 per cent of gross earnings in Canada.
- By comparison, the average production worker in the United States takes home only about 80 per cent of gross earnings.

Chart A3.9
Small business federal corporate tax rates[1]

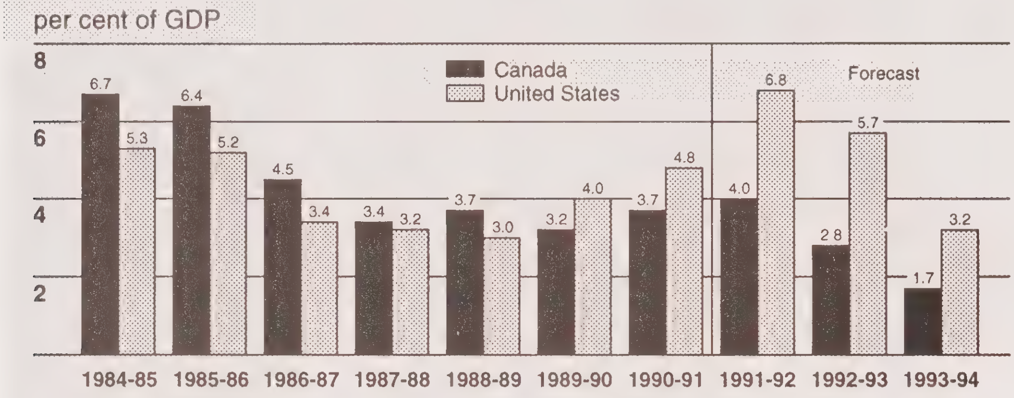


[1] Provincial and state rates also apply. On average, provincial corporate tax rates are about 8 per cent for small business and state rates are effectively about 5 per cent.
[2] Assumes exchange rate: $1 Cdn. = $0.85 U.S.

Sources: Canada: Department of Finance Canada; United States: U.S. Department of Commerce.

- Relative to the United States, the federal tax system in Canada is quite attractive for small business. The small business deduction reduces the income tax rate from 28.8 per cent to 12.8 per cent on the first $200,000 of taxable income. The United States provides lower rates over a much smaller range; full rates apply to incomes over about $88,000 in Canadian dollars. While provinces also provide reduced rates of tax for small business, provincial taxes in Canada are, on average, somewhat higher than state taxes, about 8 per cent for provinces versus about 5 per cent for states. Overall there is a significant tax rate advantage for Canadian small businesses at most income levels.
- Small business in Canada benefits from other federal tax advantages relative to their U.S. counterparts.
  - Canada's $500,000 lifetime capital gains exemption for qualified small business shares has no U.S. counterpart. Furthermore, only 75 per cent of capital gains above the exemption level are taxable whereas capital gains are fully taxable in the U.S.
  - Canada has one of the most generous systems of tax incentives for R&D in the world. Small businesses are eligible for a 35 per cent refundable tax credit for its R&D expenditures – above the general credit rate of 20 per cent.
  - Dividend income in the United States can be taxed twice, once at the corporate level and again at the personal level, whereas in Canada the dividend tax credit alleviates this double taxation.
  - Health costs in the United States bear particularly heavy on the small business sector where average costs per employee are over $3,500.

Chart A3.10
The outlook for federal government deficits
Fiscal years



Notes 1: Financial requirements for Canada and Unified Budget Basis (UBB) balance for the United States.
2: Fiscal years ending March 31 and September 30 of the same year for Canada and the U.S., respectively.

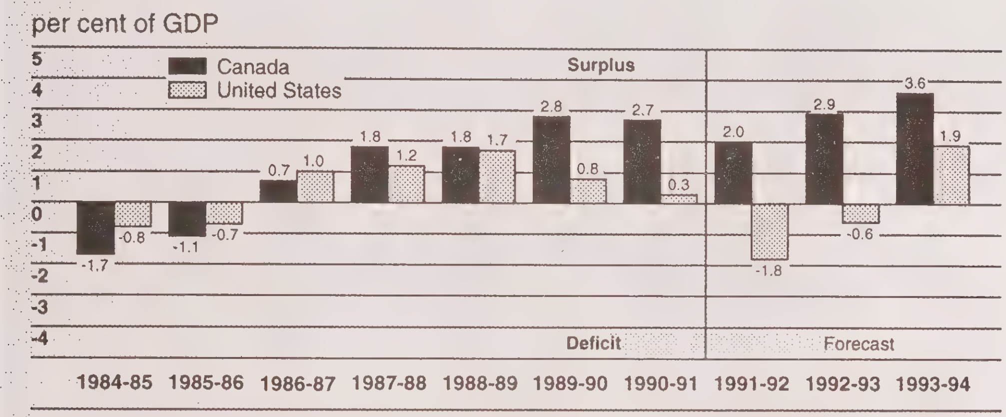
Sources: Canada: Department of Finance Canada; United States: U.S. Department of Commerce and fiscal year 1993 U.S. Budget.

- On a comparable accounting basis to that used in the United States, the deficit in Canada will decline substantially in 1992-93 and beyond due to continued spending restraint and to the expected impact of recent and projected declines in interest rates on debt servicing charges.
- From an estimated 4.0 per cent of GDP in 1991-92, the deficit is expected to decline to 2.8 per cent next year and to 1.7 per cent in 1993-94, its lowest level since 1974-75.
- Canada's federal deficit is also expected to be substantially below that of the United States over the near term. While the U.S. is expected to make considerable progress in reducing its deficit, the latter is only expected to decline to 3.2 per cent of GDP in 1993-94, almost double the level expected in Canada.

Chart A3.11

Outlook for federal government operating balance

Fiscal years



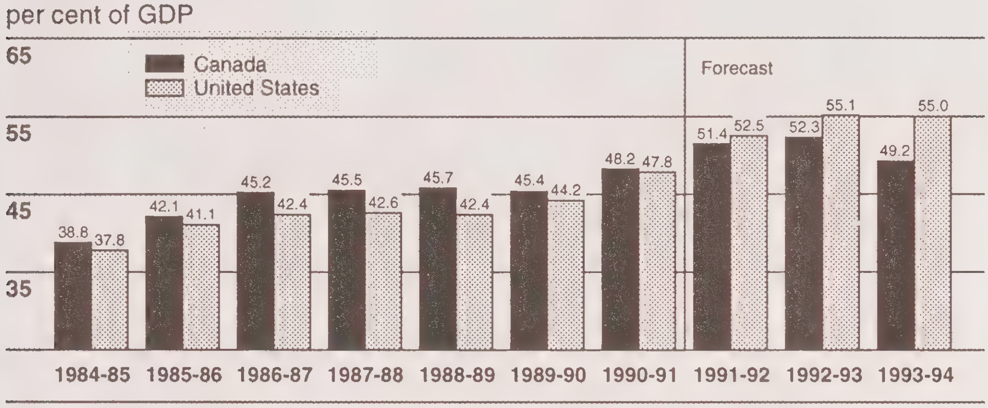
Notes 1: Financial requirements less gross debt service payments for Canada and Unified Budget Basis (UBB) deficit less gross debt service payments for the United States.

2: Fiscal years ending March 31 and September 30 of the same year for Canada and the U.S., respectively.

Sources: Canada: Department of Finance Canada; United States: U.S. Department of Commerce and fiscal year 1993 U.S. Budget.

- The federal government's operating balance is projected to improve further over the coming years. From the surplus of 2.0 per cent of GDP in 1991-92, the operating balance is expected to rise to a surplus of 3.6 per cent by 1993-94.
- By contrast, the federal government operating balance in the United States, which is expected to record a sizeable deficit in 1991-92 is not projected to be back in surplus until 1993-94.

Chart A3.12
Federal government public debt
Fiscal years



Notes 1: Debt held by outside parties for Canada and debt held by the general public for the U.S.

2: Fiscal years ending March 31 and September 30 of the same year for Canada and the U.S., respectively.

Sources: Canada: Department of Finance Canada; United States: U.S. Department of Commerce and fiscal year 1993 U.S. Budget.

- Defined on a comparable basis (federal debt excluding debt instruments held by federal governments or their agencies), federal government debt in Canada as a per cent of GDP exceeded that in the United States from 1984-85 to 1990-91. However, greater fiscal restraint in Canada has reversed the differential between the debt-to-GDP ratios of Canada and the United States in this fiscal year.
- The gap between Canada's debt-to-GDP ratio and the higher U.S. ratio is forecast to widen substantially to almost 6 percentage points over the next two years as the two ratios move in opposite directions.

CHAPTER 4: SUPPLEMENTARY INFORMATION

A. STREAMLINING GOVERNMENT

This section describes the organizations and functions being wound up or otherwise consolidated into other organizations to achieve savings in administrative overhead and other efficiencies in program delivery, and to avoid duplication.

The Canadian Institute for International Peace and Security

The end of the Cold War has been marked by a period of transition, uncertainty and instability in many parts of the world. As always, Canadian foreign policy must be informed by the best possible analysis of international events, including research and analysis done outside government. This was one of the purposes behind the creation, some seven years ago, of the Canadian Institute for International Peace and Security.

The need to husband resources, however, has led the government to reconsider how this function of independent analysis and research can best and most efficiently be performed. The government has concluded that Canada can no longer afford a separate government-funded institute for this purpose, when other sources of independent foreign policy research and analysis are available in the universities and elsewhere. Moreover, other programs of support to independent research exist elsewhere in government. *Accordingly, the Canadian Institute for International Peace and Security will be wound up. Any necessary continuing resources will be transferred to the Department of External Affairs.*

The Law Reform Commission

Since its creation in 1971, the Law Reform Commission has played a useful role in co-ordinating non-governmental research on legal issues and in providing independent advice to the Minister of Justice. The Commission has done useful work on a wide range of issues, including family and administrative law, and amendments to the Criminal Code.

The government has concluded that these functions can be adequately fulfilled by assigning responsibility for commissioning non-governmental research to the Department of Justice, and by having the Minister and Department seek the views of researchers and practitioners in universities and elsewhere. *The Law Reform Commission will be wound up and any necessary continuing resources transferred to the Department of Justice.*

The Enterprise Cape Breton Corporation

The Enterprise Cape Breton Corporation (ECBC) was created in 1987 from the Industrial Development Division of Cape Breton Development Corporation (DEVCO). Its mandate has been to promote industrial development on Cape Breton, with a particular focus on broadening the industrial base of the region outside the traditional coal and steel industries.

This is essentially a localized expression of the more general mandate of the Atlantic Canada Opportunities Agency (ACOA). *To eliminate overlap and duplication and to streamline administration, ECBC will be folded into ACOA.*

The Canadian Commercial Corporation

The Canadian Commercial Corporation (CCC) was created in 1946 to assist in the development of trade with other countries. Until 1978, the Corporation functioned effectively as a part of the Department of Supply and Services (DSS) and its predecessors. The Corporation's role as a contracting agency in support of Canadian exporters and government to government procurement can be resumed by the Department of Supply and Services. Accordingly, legislation will be introduced to wind up CCC; its functions will be absorbed by DSS.

Emergency Preparedness Canada

Emergency Preparedness Canada (EPC) was created in 1988. Prior to that time, the organization was part of the Department of National Defence.

EPC's functions in relation to planning and co-ordinating civil emergency preparedness remain essential. Separate organizational status, however, is not necessary to the effective fulfilment of these functions. *Accordingly, EPC will be folded back into DND where its functions will be continued but at lower cost in administrative overhead.*

International Development

Canada has an enviable record in international development. Current federal spending in this area totals over $3.1 billion per year. These funds are dispensed principally by the Canadian International Development Agency, increasingly through non-governmental organizations and the private sector.

The International Centre for Ocean Development

The International Centre for Ocean Development (ICOD) was established in 1983 with a mandate to support co-operation with developing countries in ocean resource development. Important though it is, this role does not require an organization distinct from Canada's major aid agency. *Accordingly, ICOD will be wound up and any necessary program resources transferred to CIDA.*

The International Development Research Centre

The International Development Research Centre (IDRC) was created by Act of Parliament in 1970 with a mandate to support research into the problems of developing regions. IDRC has a well-deserved international reputation for excellence in research. *The government will introduce legislation to change the IDRC's legal status to that of a departmental corporation. This will bring its administrative regime into conformity with that of the rest of the public service, while maintaining the Centre's distinctive research function and its international board.*

The Veterans Land Administration

The Veterans Land Administration (VLA) was created after the Second World War to provide loans and other assistance to veterans. Before lending was terminated in 1977, more than 140,000 veterans benefited from loans under the program. *The VLA will be wound up and the Department of Veterans Affairs will take steps to have the remaining portfolio of loans administered in an appropriate and economical fashion, while ensuring the interests of veterans are fully respected.*

The Patent Appeal Board, the Trade Marks Opposition Board and the Copyright Board

The Patent Appeal Board makes recommendations to the Commissioner of Patents on appeals of patent applications; the Trade Marks Opposition Board exercises authority delegated from the Registrar of Trade Marks to resolve trade mark disputes. Both are part of the Department of Consumer and Corporate Affairs. The Copyright Board is an independent tribunal responsible for fixing royalties for the re-transmission of TV and radio signals, and for resolving disputes over copyright royalties.

These three functions lend themselves well to integration in a single new board, to be called the Intellectual Property Tribunal, which will be created as an independent, arm's-length body by legislation that will be brought forward for introduction in the House.

The RCMP External Review Committee and the RCMP Public Complaints Commission

Both agencies were created in 1986. The RCMP External Review Committee reviews internal grievances and appeals by members of the RCMP; the RCMP Public Complaints Commission provides a third-party mechanism for the review of complaints from outside the Force over the conduct of a member of the RCMP.

These analogous functions can be better and more efficiently carried out by a single, independent body. This was, in fact, the option originally recommended in the 1976 report that led to the creation of the two agencies. Legislation will be introduced to give effect to this approach.

The Petroleum Monitoring Agency

The Petroleum Monitoring Agency was established in 1982 under the *Energy Monitoring Act*. Since then, it has performed a useful service to both government and industry by analyzing confidential reports from industry on the state of supplies and pricing. *This could be done at lower cost if the function were rolled into the Department of Energy, Mines and Resources. Legislation will be introduced to this end.*

The Privacy Commissioner and the Information Commissioner

Both offices were created in 1983, on the premise that separate offices were the best means of ensuring proper attention to the public's rights to access and to privacy. Since then, the two Commissioners have enjoyed common administrative support.

The government will introduce legislation to combine the two offices. This will allow for even greater administrative efficiency. More importantly from a public policy point of view, it will encourage a balancing of interests between the two objectives of privacy and access to information. This balancing becomes increasingly necessary as Canada moves away from a "single-interest" approach in a wide range of policy and program areas.

The Agricultural Products Board

The Agricultural Products Board was created in 1951. Over the years, it has provided an important service in stabilizing markets for agricultural commodities.

This function, however, can be carried out on the basis of an amended *Agricultural Products Co-operative Marketing Act*, with the continued support of the Department of Agriculture. *Legislation will, therefore, be introduced to wind up the Agricultural Products Board.*

The Procurement Review Board

The Procurement Review Board (PRB) was established under the *Canada-U.S. Free Trade Agreement Implementation Act* of 1988. It serves as an independent authority for reviewing government procurement decisions of a particular size. *However, this quasi-judicial function need not be exercised by a special purpose agency. Rather, it can be better carried out by the Canadian International Trade Tribunal (CITT) which is already involved in the resolution of international trade disputes and well-equipped to assume this additional responsibility. Legislation will be introduced to wind up the PRB and have its functions carried out by the CITT.*

The Science Council of Canada

The Science Council has played a useful role since its creation in 1966 in providing advice to government and in stimulating research and debate on issues of science policy. In the intervening years, other advisory mechanisms, both inside and outside government, have developed, including the National Advisory Board on Science and Technology which is a broadly representative body of prominent Canadians, chaired by the Prime Minister and including a number of ministers.

Resources in support of science must be rationalized to provide as much to researchers as possible and to minimize spending on overhead. *Accordingly, the government has decided that the Science Council should be wound up, and legislation to this effect will be introduced in the House.*

The Demographic Review Secretariat

The Secretariat is a unit in the Department of National Health and Welfare that performs and co-ordinates research on national demographic trends relevant to the programs of the Department. *The Secretariat will be wound up and, as necessary, these functions can be carried out elsewhere in government, or in the private sector.*

Canadian National (West Indies) Steamships Ltd.

The impending resolution in the spring of 1992 of a long-standing dispute over payment of foreign debts to this Crown corporation means that it can now be wound up as provided in the Crown Corporations Dissolution Authorization Act.

The Economic Council of Canada

The Economic Council was created by statute in 1963 with a mandate to provide independent advice to the government on matters related to the growth of Canada's economy. The Council has performed a valuable service over the years, but at this time of restraint, the government has had to carefully assess priorities for the limited funding available for arm's-length research and advice.

In the years since the creation of the Council, there has been a considerable growth in the number and quality of organizations and individuals outside government conducting independent research on economic issues. This includes foundations, private sector organizations and researchers in universities. Accordingly, *legislation will be introduced to wind up the Economic Council.*

The Pay Research Bureau

The Pay Research Bureau was established in 1957 and transferred to the Public Service Staff Relations Board when the latter was created in 1967. The Bureau carries out research

and surveys on rates of pay, benefits and conditions of employment in the public service and in the private sector, to assist in the collective bargaining process.

The need for high-quality, objective information to assist both unions and management can be better met by contract to the private sector. Accordingly, the Pay Research Bureau will be wound up.

The Canada Council, the Social Sciences and Humanities Research Council and International Cultural Programs

Notwithstanding the pressures of restraint, the government has continued to provide significant levels of funding for the arts and the humanities, recognizing the vital role of Canadian culture in fostering a vigourous and unified nation.

To further strengthen support for artistic and scholarly work by Canadians, and to enhance Canada's capacity to project our national personality and the fruits of our culture abroad, the government will combine the Social Sciences and Humanities Research Council with the Canada Council.

The new agency will have a broader mandate that will include responsibility for international cultural programs and international academic relations from the Department of External Affairs.

Canadian Race Relations Foundation

The Canadian Race Relations Foundation is an element of the government's Japanese-Canadian redress package. Legislation to create the Foundation has been passed by Parliament, but not yet proclaimed.

The government is firmly committed to the goals of improved inter-racial understanding and social harmony that are the objectives behind the creation of the Foundation. *When fiscal circumstances permit, the CRRF legislation will be proclaimed and the planned $24 million in statutory funding, including $12 million on behalf of the Japanese-Canadian community, will be allocated to this purpose.*

Canadian Heritage Languages Institute

The Canadian Heritage Languages Institute will have a mandate to preserve and enhance the use of heritage languages (i.e., languages other than English and French) across Canada. Legislation to create the Institute has been passed by Parliament but not yet proclaimed.

When fiscal circumstances permit, the government is prepared to proclaim the Canadian Heritage Languages Institute Act.

The Sentencing and Conditional Release Commission

For some time, the government has been preparing for the creation of a new, small agency whose purpose would be to promote better understanding of the relationship between sentencing and conditional release. This enterprise, though highly worthwhile, cannot be afforded under present fiscal circumstances. *Accordingly, the government will not proceed with the creation of a new Sentencing and Conditional Release Commission.*

The Co-operative Energy Corporation (CO-ENERCO)

CO-ENERCO is a publicly traded corporation in which the government currently holds a 32.5 per cent interest through a holding company, the Co-operative Energy Corporation (CEC), which is jointly owned with 37 co-operatives.

There is no public policy reason for continued government ownership of CO-ENERCO. Both the co-operative shareholders of CEC and the public shareholders of CO-ENERCO would benefit from a capital restructuring needed to facilitate the sale of the government's interest. *When this can be accomplished in a manner that does not harm the interests of minority shareholders, the government will sell its shares in CO-ENERCO.*

The Dosimetry Services Unit

This is a small unit in the Department of National Health and Welfare that provides radiation monitoring services to workers across the country. This function can be performed just as well outside government, with appropriate assurances of privacy of information and service standards. *Accordingly, the government will take steps to find a buyer and privatize the unit, while ensuring privacy and maintaining quality of service.*

The Cape Breton Development Corporation (DEVCO), the Royal Canadian Mint and the Blainville Motor Vehicle Test Centre

The government will conduct a review to determine whether it would be appropriate and practical to privatize these facilities.

A number of ministerial advisory councils, which have either fulfilled their purposes or can no longer be afforded, will also be wound up and, where necessary, legislation will be introduced to do so. These include:

International Aviation Advisory Task Force and Committee

The Committee was set up to review the international dimension of Canadian carriers' rights. With the submission of its report in 1991, the Committee's work has been completed and it will be wound up.

National Advisory Committee on Development Education

The Committee was formed in 1988 to advise the Minister for External Relations on the best ways to involve Canadian non-governmental organizations in educating Canadians about international development issues. The Committee has submitted several reports to the Minister and many of its recommendations have been acted upon. With its objectives now largely fulfilled, it can be wound up.

Canadian Environmental Advisory Council

The Council was established in 1972 to provide independent advice to the Minister of the Environment. Since then, other sources of advice to the government on sustainable development have emerged, including the National Round Table on the Environment and the Economy. Accordingly, the Council will be wound up.

Canada Employment and Immigration Advisory Council

The Council is a statutory body established in 1977 to advise the Minister of Employment and Immigration on the Department's policies and programs. This function has now been superseded by the broader consultative structure of the Canadian Labour Force Development Board. Corresponding consultative mechanisms exist on the Immigration side of the Department. As there is no longer a need for a single statutory advisory committee, it will be wound up.

Advisory Committee on Lay Members of the Competition Tribunal

The Committee was established in 1986 as part of the establishment of the Competition Tribunal. With Canada's competition regime now mature and well-functioning, there is no longer a need to maintain a separate statutory advisory committee.

Advisory Committee on La Francophonie

The Committee was established in 1990 to advise the then-Minister of Communications on his responsibilities in relation to La Francophonie. With the transfer of that responsibility to the Minister for External Relations, there is no longer a need for a separate advisory committee and associated departmental support.

Advisory Committee on Le Musée de la Nouvelle France

The Committee was established in 1990 and has provided useful advice to the Minister of Communications on resource and other issues related to a possible museum in Quebec City. The Committee is no longer required and will be wound up.

Communications Research Centre Advisory Committees (three existing committees to be integrated into one)

Until now, the government's Communications Research Centre near Ottawa has had a separate private sector advisory committee for each of its three functions – communications technology, components and devices, and broadcast technology. With the decision to establish the CRC as a distinct "institute" within DOC, the three advisory committees will be combined into one.

Montreal Science and Technology Museum Advisory Committee

The Committee was established in 1990 to provide advice to the Minister of Communications on issues related to the proposed Museum. Considerations of fiscal restraint require that the Committee be wound up.

Advisory Committee for Le Musée des arts du spectacle vivant (de la scène)

The Committee was established in 1990 to advise the Minister of Communications on issues related to the proposed Museum in Montreal. Considerations of fiscal restraint require that it be wound up.

Marine Advisory Board on Research and Development

The Board was created in the mid-1980s to advise the Coast Guard on marine research and development projects. Although the Board has done useful work, broader fiscal restraint has diminished the amount of R&D to be done in this area and there is thus no longer a need for a separate advisory committee.

B. PERSONAL INCOME TAX MEASURES

This section describes the personal income tax initiatives announced in this budget. They will lower tax burdens for Canadians, introduce a new child tax benefit, and provide additional benefits to Canadians with disabilities, students and home buyers. Changes will also be made to treat common-law couples the same as married couples.

These measures are summarized in Table 4.1. Together they will reduce taxes paid by individual Canadians by $7.5 billion over the next five years.

Lower taxes for Canadians

Over the last six years, the government has followed a consistent economic and fiscal plan designed to restore the federal government's financial position and establish the policy environment required to place the economy on a solid, more competitive footing.

The tough decisions are paying off. Steps taken to deregulate key sectors, reform the nation's tax and financial systems and open markets to freer trade have yielded an economy which is more resilient and well-positioned to take advantage of improving world economic conditions. As described elsewhere in this document, Canada's financial position has improved considerably and the outlook is for substantial, sustained progress.

Table 4.1

Federal revenue impact of personal income tax measures

Measure	1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
			(millions of dollars)			
Reduce surtax by 1% July 1, 1992 and by 1% January 1, 1993	-500	-1,250	-1,540	-1,630	-1,725	-6,645
New Child Tax Benefit	-520	-645	-315	-310	-300	-2,090
Increase the Child Care Expense Deduction	–	-10	-40	-40	-45	-135
Equal tax treatment of common-law couples and married couples	–	180	240	280	285	985
Tax assistance for Education	-10	-25	-25	-25	-25	-110
Tax measures for Canadians with disabilities	-5	-15	-15	-20	-20	-75
Home Buyers' Plan	small	small	–	–	–	small
Extension of payout period for RRIF	small	small	small	small	small	small
Delay increase in pension and RRSP limits	0	20	100	100	100	320
Interest-free processing period	0	55	55	55	55	220
Total	-1,035	-1,690	-1,540	-1,590	-1,675	-7,530

The environment has, therefore, been created which allows the federal government to begin lowering the tax burden on Canadians. This will be accomplished in two main ways. A general tax reduction for all taxpaying Canadians will be provided through a reduction in the current federal surtax. As a result of the new child tax benefit proposed in this budget, taxes will be lowered for low- and middle-income families.

Reducing the surtax

Currently, all taxpayers pay a general surtax equal to 5 per cent of basic federal tax. The budget proposes that this surtax be reduced by 1 percentage point, from 5 per cent of basic

federal tax to 4 per cent, effective July 1, 1992, and by a further 1 percentage point, to 3 per cent, effective January 1, 1993. The high income surtax of 5 per cent is unaffected.

All 14.6 million Canadian taxpayers will have their tax burden reduced as a result of this budget measure. As shown in Table 4.2, a single taxpayer earning $30,000 will receive a tax reduction of $76 in 1993. For a one-earner couple with two children and $50,000 of income the reduction will be $162.

Over the five-year fiscal framework the proposed change represents a cut in personal taxes of $6,645 million.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
		(millions of dollars)			
-500	-1,250	-1,540	-1,630	-1,725	-6,645

Table 4.2

Impact of surtax reduction

Income level	Current surtax	Tax reduction in 1992	Tax reduction in 1993
	(dollars)		
Single taxpayer[1]			
15,000	66	7	27
20,000	107	11	43
30,000	189	19	76
40,000	317	32	127
50,000	447	45	179
60,000	578	58	231
75,000	966	80	318
100,000	1,691	116	463
One-earner couple with two children			
15,000	21	2	8
20,000	61	6	24
30,000	147	15	59
40,000	275	27	110
50,000	405	40	162
60,000	525	52	210
75,000	860	74	297
100,000	1,585	111	442

[1] Taxpayers are assumed to be under age 65, receive income from earnings, and claim standard credits and deductions.

AN ENRICHED CHILD TAX BENEFIT

Beginning January 1993, the existing patchwork of child benefits will be replaced by a new Child Tax Benefit paid monthly, generally to the mother.

- The family allowance, child credit and refundable child tax credit will be consolidated into one unified benefit of $1,020 per child.
- The basic $1,020 Child Tax Benefit will be increased by:
  - $75 for the third and each subsequent child in a family; and
  - $213 per child under age seven where no child care expenses are claimed.
- For low-income working families with children, the Child Tax Benefit will also include a new earned-income supplement of up to $500 per family.

Over 3.1 million families will continue to receive a monthly cheque, as they currently do under the family allowance program. However, unlike the family allowance, the new benefit for any year will neither be taxed nor recovered on filing the tax return for that year at tax time.

A White Paper proposing an improved child benefit system is being released by the Honourable Benoît Bouchard. The new system is simpler, fairer and more responsive to the needs of Canadians. It will result in a significant tax reduction for many families. The Minister of National Health and Welfare will begin discussions with his provincial colleagues and other interested parties on the implementation of this new benefit.

The Child Tax Benefit will increase benefits to families with children by nearly $2.1 billion over five years.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
		(millions of dollars)			
-520	-645	-315	-310	-300	-2,090

INCREASE THE CHILD CARE EXPENSE DEDUCTION

The budget increases by $1,000 the maximum expenses for child care that may be claimed for the 1993 and subsequent taxation years. Thus, the maximum child care expense that may be claimed will be:

- $5,000 for each eligible child who is less than seven years of age at the end of the year or has a severe and prolonged mental or physical impairment for which a Disability Credit Certificate has been submitted; and
- $3,000 for each older eligible child who is less than 15 years of age at the end of the year or who is not eligible for the $5,000 deduction but has a mental or physical infirmity.

The child care expense deduction provides important recognition of the costs incurred by single parents and two-earner families. Through this deduction the federal government

provides about $300 million in tax assistance to over 600,000 taxpayers, of whom three-quarters are women. In the case of married taxpayers, only the spouse with the lower net income may claim child care expenses.

For middle-income families, this measure will provide additional federal and provincial tax benefits of about $400 per year for each child.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
(millions of dollars)					
0	-10	-40	-40	-45	-135

Reduced surtax, the child tax benefit and increased child care expense deduction: The combined effect

The surtax reduction provides tax relief for all taxable Canadians. The new child tax benefit focuses benefits on low- and middle-income families with children.

The table below compares the level of child benefits under the current system and under the proposed child tax benefit. Virtually all low- and middle-income families will receive more benefits than under the current system. Since the child tax benefit takes the form of a tax credit, this means that low- and middle-income families will pay less tax under the new system.

Table 4.3
Child benefit levels for families with two children

	Current system[1]			New system
Family income	Single parent[2]	One-earner	Two-earner	All families
	(dollars)			
0	2,040	2,040	2,040	2,040
10,000	2,040	2,040	2,040	2,540
20,000	1,925	2,040	2,040	2,540
30,000	1,559	1,672	1,792	1,836
40,000	1,059	1,172	1,292	1,336
50,000	602	716	716	836
60,000	114	227	716	336
75,000	117	234	716	0
100,000	117	234	227	0

[1] Benefits include the family allowance, the federal-provincial value of the child credit and the refundable child tax credit.

[2] Taxable single-parent families with children also receive about $1,445 in additional federal/provincial benefit through the equivalent-to-married credit.

The above table shows that, under the current system, middle-income two-earner families receive higher child benefits than either single parents or one-earner couples. Two-earner families have an advantage because family allowance is recovered on the basis of individual, rather than family, income. For example, a one-earner family with two children earning $60,000 is subject to a full recovery of family allowance, while no part of the allowance is recovered from a two-earner family with each spouse earning $30,000. The new system of child benefits provides the same level of benefit per child to families in similar financial circumstances.

As the above table also shows, single parents and one-earner couples with incomes up to $60,000 will receive larger child benefits under the new system. Two-earner families with incomes above $50,000 will receive lower benefits because the new child tax benefit will be reduced on the basis of family, rather than individual, income. However, for single-parent and two-earner families with maximum child care expenses, the increase in the child care expense deduction will provide up to $400 of additional tax relief per child.

The surtax not only provides additional tax relief for low- and middle-income families, it also extends this relief to all other taxpayers. The following table shows the overall impact of the child tax benefit and surtax reduction on Canadian families. The combined impact of these changes means that approximately 9.1 million families will benefit from a tax reduction and less than half a million families will receive lower benefits.

Table 4.4

Impact of child tax benefit and surtax reduction on families with two children, 1993[1]

Change in taxes

Family Income	Single parent	One-earner	Two-earner
	(dollars)		
0	0	0	0
10,000	-500	-500	-500
20,000	-639	-526	-523
30,000	-377	-263	-139
40,000	-386	-272	-129
50,000	-394	-281	-239
60,000	-435	-322	+218
75,000	-183	-66	+488
100,000	-328	-211	-131

[1] Does not include possible benefit from the increase in the child care expense deduction.

THE TAX TREATMENT OF COMMON-LAW COUPLES

In general, the Canadian income tax system does not recognize common-law couples and, as a result, their tax treatment is often different from that of married couples. This issue has increased in importance in recent years as the number of common-law couples has grown significantly, more than doubling in the 1980s, to about 775,000 in 1990.

In some cases, the differences in tax treatment can penalize common-law couples. For example, under the current system, a one-income common-law couple cannot claim the married credit. Compared to a married couple, this can result in more than $1,400 in additional taxes.

In other cases, common-law couples may receive a benefit. For example, unlike married couples, many common-law couples are not required to combine their incomes for the purpose of determining their eligibility for the GST credit or the refundable child tax credit. This can be worth more than $1,000 for a common-law couple with one child. In addition, a two-income common-law couple with children can use the equivalent-to-married credit for a dependent child.

This budget proposes changes to treat common-law couples the same as married couples under the tax system for 1993 and subsequent taxation years. The broader definition of "spouse" that is currently used only for the purpose of the provisions relating to pensions and other retirement plans will be extended for all purposes of the *Income Tax Act*. Under this broader definition, a spouse will include both a married and a common-law spouse. A common-law spouse of an individual will be defined as a person of the opposite sex with whom the individual is currently cohabiting in a conjugal relationship. At any time, the two individuals must have had such a relationship for at least 12 months or must be the natural or adoptive parents of a child to be considered common-law spouses.

The 1992 tax form will seek the information required to implement this new measure. However, it will only begin to apply in taxation year 1993.

As a result of this change, common-law couples will be:

- eligible for the married credit;
- permitted to contribute to spousal RRSPs;
- unable to claim the equivalent-to-married credit;
- required to combine their incomes for 1992 and subsequent years for the purposes of determining the amount of the GST credit payable beginning in July 1993 and monthly payments of the new Child Tax Benefit beginning in July 1993; and
- subject to the attribution rules and other provisions that apply to married taxpayers.

Treating common-law couples the same as married couples ensures consistent tax treatment of different types of families.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
(millions of dollars)					
0	180	240	280	285	985

TAX ASSISTANCE FOR EDUCATION

The following tax relief is currently available to students in Canada:

- An education credit relieves from tax $60 for each month of full-time study;
- A 17 per cent credit in respect of tuition fees; and
- An exemption of $500 of scholarship, fellowship or bursary income.

If a student does not have sufficient income to take advantage of the education and/or the tuition fee credits, a supporting parent, grandparent or spouse may claim them, up to a maximum of $600. This transfer recognizes that some students are not in a taxable position and are supported by their family.

This budget provides additional tax relief to students by increasing the education credit and the total value of the credits which may be transferred to parents or other supporting taxpayers. This will assist full-time, post-secondary students. The change will be effective for the 1992 and subsequent taxation years.

As a result of this change, the dollar limit on which the education credit is calculated will be increased by one-third, to $80 per month of full-time study. In addition, the limit on the total amount of tuition fee and education credits that may be claimed by another taxpayer will be increased from $600 to $680. These changes will benefit 600,000 students claiming the education credit and 400,000 taxpayers claiming the transfer.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
		(millions of dollars)			
-10	-25	-25	-25	-25	-110

TAX MEASURES FOR CANADIANS WITH DISABILITIES

In recent years a number of important tax measures have been introduced to assist Canadians with disabilities. Prior to 1986, tax assistance under the disability deduction was granted only to those disabled Canadians who were blind, or confined to a bed or wheelchair. In 1986, the eligibility criteria for this benefit were broadened to include all Canadians who are markedly restricted in their activities of daily living. In 1988, the deduction was converted to a credit and enriched. In 1991, the level of the credit was further increased by $125 to $700. This increases the amount of federal tax assistance to Canadians with disabilities by $35 million per year to an annual total of about $375 million. As a result, the number of credit recipients increased from about 85,000 individuals in 1985 to 410,000 in 1990.

In addition to these tax measures, the government announced a five-year $158 million National Strategy for the Integration of Persons with Disabilities. Its key goals are: equal access; economic integration; and effective participation by Canadians with disabilities in the mainstream of our national life.

The government is continuing to work with groups representing Canadians with disabilities to improve the effectiveness of the tax system in meeting their needs.

This budget proposes several new measures to assist and to promote employment opportunities for people with disabilities. These proposals have resulted from this ongoing consultation process.

New eligible expenses for the medical expense tax credit

The government reviews advances in health care on a continuing basis to identify new medical expenses of importance to persons with disabilities that may be eligible for the medical expense credit. As a result of this review, several new medical expenses will be added to the list of expenses eligible for the medical expense credit.

Additional expenses that may be claimed beginning in the 1992 taxation year include:

- visual or vibratory signalling devices (e.g., visual fire alarm indicators) for those with a hearing impairment; and
- payments for rehabilitative therapies to adjust for speech or hearing loss, including training in lip reading and sign language.

Access and employment-related initiatives

To assist businesses to accommodate disabled customers or employees, the 1991 budget allowed businesses to claim an immediate deduction for the full costs of disability-specific modifications to existing buildings and devices such as interior or exterior ramps, hand-activated power door openers, alterations to bathrooms, and the widening of doorways. This change was intended to help Canadians with disabilities to participate more fully in everyday activities.

The following will be added to the list of devices eligible for immediate write-off for costs incurred after budget day:

- elevator car position indicators for those with a visual impairment (e.g., braille panels, audio indicators);
- visual fire alarm indicators for people with a hearing impairment;
- telephone devices for people with a hearing impairment;
- listening devices for group meetings for people with hearing impairments (e.g., FM loop systems); and
- disability-specific computer software and hardware attachments.

The education credit and Canadians with disabilities

Education is an important element in ensuring equal opportunities in the work place for Canadians with disabilities and in promoting their integration in society.

The importance of a post-secondary education is recognized through the tax system by the education and tuition fee tax credits. While the tax credit for tuition fees is available to individuals enrolled full-time or part-time in a qualifying post-secondary educational institution in Canada, the education credit may only be claimed by individuals in full-time attendance.

People with disabilities, however, are often unable to attend a post-secondary institution on a full-time basis because of their disability. To improve their education opportunities, the education credit will be made available to individuals with disabilities who attend a qualifying post-secondary educational institution on a part-time basis. This change will apply for the 1992 and subsequent taxation years.

CPP/QPP disability benefits and RRSPs

The amount of the deduction allowed an individual for contributions to an RRSP depends on the individual's earned income. The budget proposes to change the definition of "earned income" for this purpose to include disability pensions paid under the Canada Pension Plan/Québec Pension Plan (CPP/QPP).

This measure recognizes that CPP/QPP disability pensions replace the earnings of a disabled individual. It makes the tax treatment of these benefits consistent with the existing tax treatment of taxable long-term disability benefits from private plans. Over 230,000 Canadians receive CPP/QPP disability pensions.

The definition of earned income will be changed, effective for 1991, for the purpose of RRSP contributions for the 1992 and subsequent taxation years.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
		(millions of dollars)			
-5	-15	-15	-20	-20	-75

Home Buyers' Plan

The budget proposes to introduce a special Home Buyers' Plan. This measure will allow home buyers to withdraw existing funds from registered retirement savings plans (RRSPs) to finance the purchase of a home without having to pay tax on the withdrawal. To ensure that the role of the RRSP in providing funds for retirement is not compromised, those who participate in the plan will have to repay the amount they withdraw to their RRSP over a fixed period of time.

The introduction of the Home Buyers' Plan will stimulate home construction and job creation. This measure will take effect immediately and will be available until March 1, 1993.

How the plan works

Under this new initiative home buyers will be able to withdraw up to $20,000 of existing funds from their RRSPs for a downpayment on a home without having to pay tax on the withdrawal. The home may be a new or an existing one. It must be bought or built to be occupied as the home buyer's principal residence.

RRSP withdrawals will be repayable to the home buyer's RRSP in equal instalments over a 15-year period. For example, if a home buyer were to withdraw $15,000 from an RRSP under this measure, the scheduled annual repayment would be $1,000 per year ($15,000 divided by 15 years). The first repayment must be made by December 31, 1994.

If, in any year, the individual decides not to repay the scheduled amount or decides to repay only part of it, the amount that is not repaid will be treated as a permanent withdrawal from the RRSP and included in the individual's income for the year and, consequently, will be subject to tax. For example, if an individual with a scheduled annual

repayment of $1,000 in a year were to repay only $700 to his or her RRSP, the $300 shortfall would be included in the individual's income for the year.

Many individuals participating in the Home Buyers' Plan will want to restore the balance in their RRSP as soon as circumstances permit in order to better provide for their retirement. Such individuals may choose to repay more than the scheduled annual repayment in any year. This will result in a lower outstanding balance and lower scheduled annual repayments for the remainder of the pay-back period.

As the purpose of the plan is to provide access to existing RRSP funds, no deduction will be provided for RRSP contributions made by plan participants during the period February 25, 1992 to March 1, 1993 except those contributions that are deducted in computing income for 1991.

In order to permit prospective home buyers to take advantage of this initiative as soon as possible, details of this program, an information booklet and Eligibility Certification Forms are now being distributed to Revenue Canada District Taxation Offices across the country for distribution.

The estimated revenue costs of this measure are small.

EXTENSION OF THE PAYOUT PERIOD FOR RRIFS

By the end of the year in which an RRSP holder reaches age 71, the proceeds of the plan must be used to purchase either an annuity or a registered retirement income fund (RRIF).

Under the current rules, a RRIF holder must withdraw a minimum amount each year equal to the start-of-year balance divided by "90 minus age". For example, taxpayers who reach 71 years of age in 1992 must withdraw in that year at least 1/19th or 5.26 per cent of the value in their RRIF as determined at the beginning of that year. In the year the RRIF holder attains age 90, the full balance at the beginning of the year must be withdrawn. At the option of the RRIF holder, the minimum amount required to be withdrawn may be based instead on the age of the RRIF holder's spouse.

The concern has been raised that, under the existing rules, RRIFs cannot provide a life income for the substantial number of RRIF holders who can be expected to live beyond age 90. Of Canadians who attain the age of 71, about one-third will live beyond age 90.

The RRIF provisions will be amended to permit RRIF withdrawals to extend over the remaining lifetime of the RRIF holder (or the RRIF holder's spouse). To achieve this, the current rules will be replaced by a schedule of minimum payment percentages.

The new schedule of minimum withdrawal amounts has been determined so that the level of withdrawals can increase from year to year up to age 94. This will provide a basic level of protection from the effects of inflation.

For age 94 and subsequent years, the minimum payments will be 20 per cent of the value of the RRIF funds at the beginning of the year. This ensures that RRIF payments may continue for the life of the taxpayer.

The table below compares the new minimum payment percentages to those under the existing rules. In order to limit the tax deferral costs of extending the RRIF payout period

for life, minimum payment fractions are slightly increased under the new rules for ages 71 to 77.

The new rules apply to all RRIFs to which funds are transferred after the end of 1992. For most RRIFs that exist now or are purchased before the end of 1992 (called "qualifying RRIFs"), the existing minimum payment percentages will continue to apply for ages up to age 77. However, the lower minimum payment percentages for ages above age 78 will apply to all RRIFs regardless of the date of purchase. This will ensure a smooth transition to the new rules.

The estimated revenue costs of this measure are small.

Table 4.5

Required minimum payments as a per cent of RRIF assets

Age[1]	Existing rules	New rules
	(per cent)	
71	5.26	7.38
72	5.56	7.48
73	5.88	7.59
74	6.25	7.71
75	6.67	7.85
76	7.14	7.99
77	7.69	8.15
78	**8.33**	**8.33**
79	9.09	8.53
80	10.00	8.75
81	11.11	8.99
82	12.50	9.27
83	14.29	9.58
84	16.67	9.93
85	20.00	10.33
86	25.00	10.79
87	33.33	11.33
88	50.00	11.96
89	100.00	12.71
90	0.00	13.62
91	0.00	14.73
92	0.00	16.12
93	0.00	17.92
94	0.00	20.00
95	0.00	20.00
96	0.00	20.00
97	0.00	20.00
98	0.00	20.00
99	0.00	20.00
100+	0.00	20.00

Note: For ages below age 71, the existing minimum payment fractions will continue to apply.

[1] Age at the beginning of the year of the RRIF holder or, where the RRIF holder elects, the RRIF holder's spouse.

DELAY IN INCREASE OF PENSION AND RRSP LIMITS

The budget proposes to delay the phase-in of higher contribution limits for registered pension plans (RPPs) and registered retirement savings plans (RRSPs). This measure will produce fiscal savings and help to encourage spending rather than saving during the period of economic recovery.

Table 4.6

Dollar limits on contributions to RPPs and RRSPs

	RPPs		RRSPs	
	Existing	Modified	Existing	Modified
	(dollars)			
1991	12,500	12,500	11,500	11,500
1992	13,500	12,500	12,500	12,500
1993	14,500	13,500	13,500	12,500
1994	15,500	14,500	14,500	13,500
1995	Indexed	15,500	15,500	14,500
1996		Indexed	Indexed	15,500

Notes: 1. The RPP amounts are for money purchase plans. The dollar limits on contributions to deferred profit sharing plans will remain at one-half the dollar limits on RPP contributions.

2. To ensure that benefits under defined benefit pension plans are limited in a manner that is consistent with the treatment of contributions to money purchase plans, indexing of the maximum pension limit of $1,722 per year of service will be deferred to 1996 rather than beginning in 1995.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
(millions of dollars)					
0	20	100	100	100	320

INTEREST FREE PROCESSING PERIOD

Each year the government issues over 12 million personal income tax refunds. Currently, interest is paid on tax refunds as of the filing deadline, which is generally April 30th of the following year. Late returns earn refund interest as of the date filed. In other countries, there is an interest free period after the filing deadline for processing returns and sending out refunds. It is proposed that the same approach be adopted in Canada.

Under the proposed procedure, interest will not start to accumulate until 45 days after the filing deadline (or 45 days after actual filing if it is later). The change is to become effective for tax returns filed after 1992.

The amount of interest which accumulates on an average refund during the 45 days following April 30th is relatively small – on average about $5 to $10 per return. The interest free processing period will save the government $55 million per year.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
(millions of dollars)					
0	55	55	55	55	220

C. Competitiveness and the Tax System

Background

Canada's tax system – personal, corporate, sales and excise – is called upon to satisfy a number of objectives:

- provide a stable, predictable fiscal environment in which Canadians can save and invest;
- contribute to fairness and help achieve society's income redistribution goals;
- raise substantial amounts of money, necessary to finance government programs which benefit all Canadians, such as health care and education; and
- do so in a way that contributes to economic efficiency and does not bias private sector decisions by distorting market signals.

In structuring the tax system to achieve these objectives, an important overall consideration is the international competitiveness of Canada's economy and the extent to which tax policies can enhance our competitive position. While taxes are a factor, they alone cannot solve competitiveness problems. The overall economic situation, conditions in product markets, the institutional framework and, in particular, actions by business and labour to enhance productivity and contain costs will be more important than taxes. For example, actions to stabilize inflation and reduce interest rates will have a substantial and lasting impact on Canada's long-term prosperity by, among other things, lowering the cost of capital for productive investment. Similarly, reducing the deficit through expenditure restraint will provide scope to lower the federal tax burden on Canadians.

The effectiveness of the tax system in promoting a competitive economy depends both on the general level of taxation and the mix and structure of individual taxes. Provincial taxes and their relationship to federal taxes are clearly important in a federal system.

Major changes to the federal income and sales tax systems in the last several years have dramatically improved the structure of the Canadian tax system. These reforms were aimed at reducing the impact of taxes on business decisions and sharing the burden of taxation more equitably across the economy.

OECD analysis of tax reform

The Organization for Economic Co-operation and Development (OECD) reviewed the impact of tax reform in its Economic Survey on Canada for 1989-90, and said:

"Once reforms are fully implemented, the Canadian tax system will be less distortionary and better protect the real after-tax income position of low income recipients. It will also strengthen Canada's international competitive position, important for realising the potential benefits of structural reform initiatives, notably free trade".

Reforms to the income tax system broadened the tax base, lowered tax rates, and minimized the use of specific incentives, so that decisions of individuals and businesses would be based more on market signals than on tax considerations.

Reforms to the sales tax system removed the bias in the federal sales tax against domestic manufacturers competing with importers and removed the hidden tax on business inputs of exporters.

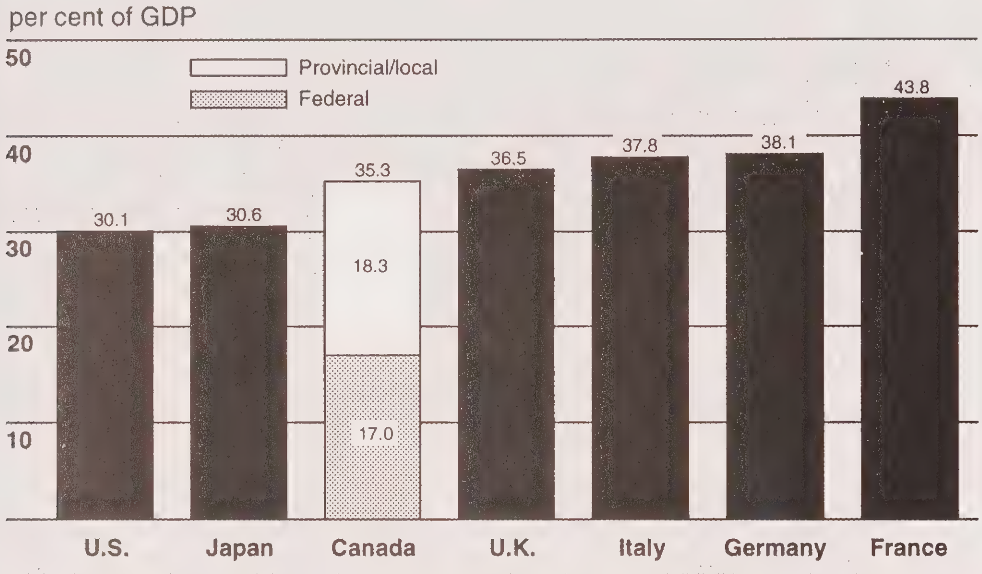
Taken together, these changes have resulted in a tax system that is more supportive of economic growth, investment and competitiveness. In addition, the reforms provide a more secure and stable tax structure, vital to providing the revenue necessary to manage the deficit.

The level of taxes collected in Canada is roughly in line with that in other developed countries. In 1989, total tax revenues in Canada were about 35 per cent of GDP. The federal government collects just under one-half of this total, and provincial and local governments collect just over one-half. Chart 4.1 shows that Canada has the third lowest overall tax burden as a percent of GDP among the G-7 countries.

The level of taxation in Canada cannot be viewed in isolation from the level of expenditures and the fiscal position of the government. The level of taxation is determined largely by the demand for government services, which reflects citizens' values. For example, in Canada, health care services and support for training and education are important publicly provided services. While these do require increased tax revenues, they reduce the private costs incurred by businesses and individuals. This must be recognized in international comparisons.

In the 1991 budget, the government announced that as part of its Prosperity initiative, the tax system would be examined to see if improvements could be made. This budget proposes a series of important federal initiatives that will improve the competitiveness of the Canadian economy. These measures are summarized in Table 4.7.

Chart 4.1
Level of tax revenues in G-7 countries, 1989



Source: Revenue statistics of OECD member countries, 1965-1990 (latest available data 1989).

A comparison of health care costs, Canada and the United States

In the United States, the proportion of national income allocated to health care has risen dramatically. Over the last twenty years, U.S. health care costs as a percentage of GDP have risen from 7.4 to 11.0 per cent. In Canada, costs have risen from 7.1 to 8.7 per cent. Canada spends a smaller percentage of its income on health care, yet covers the entire population. Over 30 million Americans, many of whom are working adults, lack health insurance.

Private health care costs paid by employers are four to five times higher in the United States than in Canada. While in Canada most employers provide some type of supplementary health coverage, the bulk of those costs are covered by public health insurance programs. However, in the United States, employees rely more heavily on privately-funded insurance to cover their health care costs.

Health care costs are even higher for small businesses in the United States, which cannot benefit from the discounts given by insurers to larger businesses. In the United States, annual health care costs per employee for small businesses now average over $3,500 (in Canadian dollars) according to a study prepared by the National Federation of Independent Business.

Table 4.7

Measures to enhance competitiveness

Federal revenue impact

Measure	1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
			(millions of dollars)			
Increase Capital Cost Allowance rate on manufacturing and processing equipment from 25% to 30%	-40	-110	-160	-195	-225	-730
Reduce tax rate on manufacturing and processing profits by two percentage points	0	-150	-400	-470	-530	-1,550
Reduce withholding tax rate on direct dividends from 10% to 5%	-10	-55	-95	-125	-145	-430
Streamline administration of SR&ED tax credits	0	-50	-55	-60	-65	-230
Target capital gains exemption toward equity	10	80	210	315	365	980
Enhance incentive for labour sponsored venture capital funds	0	-5	-5	-5	-5	-20
Small business financing measures	-20	-20	-10	-10	-10	-70
Total	-60	-310	-515	-550	-615	-2,050

MANUFACTURING AND PROCESSING

The manufacturing and processing (M&P) sector accounts for almost one-fifth of Canada's GDP and employment. Its economic health is an important determinant of Canada's prosperity. The sector is also one which is highly exposed to international competition. This exposure will continue to grow, as barriers to flows of goods, services and capital among countries fall and as technological advances cause production location decisions to become increasingly flexible. This situation presents an opportunity for Canadian firms to expand and grow, particularly in the manufacturing and processing sector, where over 40 per cent of our output is exported. At the same time, it means that Canadian firms face increased competition for international investments and market share.

The manufacturing and processing sectors of all economies are in the process of restructuring. This process is not complete in Canada. More has to be done to ensure that Canada's manufacturing and processing sector remains competitive in world markets.

Three tax changes have been identified which will enhance the competitiveness of Canada's manufacturing and processing sector. These changes will assist it in restructuring its operations to improve productivity to take advantage of the opportunities presented by liberalized global markets:

- an increased rate of capital cost allowance (CCA) in respect of purchases of manufacturing and processing machinery and equipment;
- a reduction of the tax rate on manufacturing and processing profits; and
- a reduction of the withholding tax rate on direct dividends.

Capital cost allowance

The rate at which the cost of capital can be deducted in calculating income subject to tax plays a very important role in investment decisions. The early, or "up front" deduction of CCA means that after-tax costs are lowered when they are most important – in the early years. As a result, the financial rate of return on a project can be increased.

The government proposes to increase the capital cost allowance rate for eligible manufacturing and processing machinery and equipment from the current rate of 25 per cent to 30 per cent.

The increased CCA rate will apply to acquisitions after budget day of manufacturing and processing machinery and equipment that would otherwise be included in Class 39 of Schedule II to the Income Tax Regulations.

Property eligible for increased CCA rate (Class 39)

Property eligible for Class 39 includes machinery and equipment to be used directly or indirectly in the manufacturing or processing of goods for sale or lease.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
(millions of dollars)					
-40	-110	-160	-195	-225	-730

Reduction in Manufacturing and Processing Tax Rate

The increased CCA rate for manufacturing and processing machinery and equipment will improve Canada's competitive position in attracting new investment. Investors are also influenced by the statutory tax rate which affects the long-term financial return and the economic attractiveness of a particular jurisdiction. Relative tax rates between countries also affect the allocation of income and expenses by multinational companies. These companies have an incentive to arrange their activities in such a way as to have income earned in jurisdictions with low tax rates and to have financing and other costs increased in jurisdictions with high tax rates. Clearly, these arrangements reduce tax revenues in countries with high tax rates.

The importance of these factors in the manufacturing and processing sector is reflected in the fact that the tax rate applied to profits in that sector has historically been lower than the general tax rate on corporate income.

Currently, manufacturing and processing income is eligible for a five percentage point reduction from the general tax rate – reducing the tax rate on these profits from 28 per cent to 23 per cent.

The budget proposes a further reduction in this rate to 21 per cent. This change will be phased in, with a one percentage point decline effective January 1, 1993 and another percentage point decrease effective January 1, 1994.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
		(millions of dollars)			
0	-150	-400	-470	-530	-1,550

WITHHOLDING TAX REDUCTIONS ON DIRECT DIVIDENDS

The *Income Tax Act* imposes a withholding tax of 25 per cent on dividends paid to non-residents. Canada has reduced the rate for many countries through bilateral tax treaty negotiations. In the past, Canada has been prepared to reduce the withholding tax rates in our tax treaties with our major trading partners to 15 per cent for portfolio dividends and 10 per cent for direct dividends – those paid by a Canadian affiliate to a foreign parent or other corporation with a substantial interest in the affiliate.

The rate of withholding tax on dividends has an effect similar to that of the statutory tax rate on the decisions of foreign-owned firms that are considering new investments in Canada or expansion of their existing Canadian operations. The withholding tax imposed on the after-tax earnings distributed by a Canadian subsidiary can represent an additional tax burden to the multinational company and thereby result in lower investment in Canada. Since withholding taxes are negotiated on a reciprocal basis, high withholding taxes on direct dividends can also hinder the investment plans of Canadian-based multinational companies.

Most direct dividends paid out of Canada are subject to a 10 per cent withholding tax rate. This rate is higher than the rates that many other countries are prepared to accept. The OECD model treaty, generally used as a basis for tax treaty negotiations, suggests a withholding tax rate of 5 per cent for dividends. In addition, members of the European Economic Community have agreed to eliminate withholding taxes on direct dividends between community members as of January 1, 1992.

In today's international environment where investment capital is mobile across international boundaries, a high rate of withholding tax acts as an impediment to capital flows and inward investment. In the midst of a process of worldwide restructuring, Canada must not act in ways that hinder our ability to attract a good share of new worldwide investment.

For this reason, the government is prepared, in its tax treaty negotiations, to commence to reduce the withholding tax rate on direct dividends beginning January 1, 1993. The rate would be reduced to 5 per cent over a 5-year period. Any rate reductions would be reciprocal, benefiting Canadian firms investing abroad as well as foreign firms investing in Canada. This proposed reduction in the withholding tax rate would benefit firms in all sectors of the economy.

Revenue impact

Assuming that the reductions commence in 1993

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
		(millions of dollars)			
-10	-55	-95	-125	-145	-430

Impact of changes

These three important structural changes will have a positive influence on the manufacturing and processing sector's investment plans for Canada by increasing the rate of return on new investments. Consequently, firms will have an incentive to allocate more of their investment to Canada.

The immediate increase in capital cost allowance rates will provide an incentive for firms to shift investment from 1993 and 1994 into 1992. By doing so, these firms will receive a greater tax benefit since these increased depreciation allowances will reduce income subject to tax at a 24 per cent rate (including the 3 per cent surtax) in 1992 as compared to the lower rates of 23 per cent and 22 per cent in the following years. Reprofiling of investment will aid the recovery of the economy in 1992.

The following table illustrates the benefits of the reduction in the M&P tax rate and the withholding tax rate, when fully phased in. Consider a U.S. company deciding whether to expand its manufacturing operations in the U.S. or that of its subsidiary in Canada. Before the changes proposed in this budget, the Canadian subsidiary faced a four point disadvantage in tax rate. With the proposed changes, including the reduction in the M&P tax rate, the average statutory tax rate on income earned in the Canadian subsidiary would decline by five percentage points, making the rate lower than in the U.S.

For a Canadian company (which is not subject to the withholding tax), the rate reduction will provide a significantly lower statutory tax rate in Canada than its competition in the United States (35 per cent versus 39 per cent).

Table 4.8

Effective statutory tax rates on M&P income earned in Canada and the United States

	Income earned in Canadian subsidiary		Income earned by U.S. parent
	Current	Proposed	
		(per cent)	
Federal[1]	24	22	34
Provincial/state[2]	13	13	5
Total income tax	37	35	39
Net withholding tax[3]	6	3	n/a
Total income and withholding tax	43	38	39

[1] Basic M&P tax rate plus the 3 per cent surtax.

[2] Provincial and state tax rates are averages. Actual rates will vary across jurisdictions. The state tax rate reflects the fact that state taxes are deductible for federal tax purposes in the United States.

[3] The withholding tax applies to dividends paid to the foreign parent out of after-tax income of the subsidiary.

Impact of budget changes on the incentive to invest, Canada and the United States

Any comparison of the tax regimes in various countries should consider the impacts of the tax systems as a whole, not just individual components, such as depreciation rates.

Marginal effective tax rates are often used as a measure of the effects of a tax system on investment decisions. This calculation takes into account the overall effects of the statutory corporate income tax rate, depreciation rates, and provincial/state taxes.

The impact of the changes announced in this budget is shown in the following table. It compares the marginal effective tax rate on an investment in machinery and equipment by a large manufacturing company, Canada and the United States.

	Current	Proposed
	(per cent)	
Canada	23.4	20.6
United States	21.6	21.6
Difference	1.8	-1.0

The changes proposed in this budget will lower the marginal effective tax rate on an investment in machinery and equipment in Canada by a large manufacturing company by about 2.8 percentage points – making it about one percentage point lower than the marginal effective tax rate on a comparable new investment in the United States.

Scientific Research and Experimental Development (SR&ED)

Research and development programs make possible the creation of new and better technologies. The benefits of successful research and development activity typically extend beyond the actual firms involved and into the economy more generally. For this reason, the importance of research and development has been emphasized in the government's consultations on prosperity.

Recent studies by the Conference Board and others have shown that Canada has one of the most generous systems of SR&ED tax incentives in the world. The key features are the 100 per cent write-off for all SR&ED expenditures (both current and capital, other than buildings) and the investment tax credit for these expenditures undertaken in Canada.

The SR&ED tax credit

The current federal income tax incentives for Canadian SR&ED include full deductibility of both current expenses and certain capital expenditures. In addition, these expenditures are eligible for an investment tax credit of at least 20 per cent. The credit is increased to 30 per cent for SR&ED expenditures incurred in the Atlantic provinces and the Gaspé region.

Qualifying Canadian-controlled private corporations are eligible to receive a tax credit of 35 per cent of qualifying SR&ED expenditures. Unused amounts of the 35 per cent SR&ED tax credit are fully refundable in respect of the first $2 million of current expenditures per year. Unused tax credits earned in respect of current expenditures exceeding the $2 million limit and capital expenditures qualify for a 40 per cent refund.

In 1989, Canadian firms earned in excess of $800 million in SR&ED investment tax credits – over $100 million of this amount was delivered as tax refunds.

In the 1991 federal budget, the government indicated that it would be examining whether modifications to the SR&ED tax credit could ease its administration for taxpayers. Since that time, the Department of Finance, in co-operation with Revenue Canada and the Department of Industry, Science and Technology, has been engaged in discussions with major industry groups and individual firms.

These discussions have shown that there is room for improvement. This budget proposes to streamline the administration of the SR&ED tax credit system to make it more effective. As a result of these changes, the SR&ED tax credit system will be enriched by about $230 million over the next five years.

This budget identifies the areas for change and these are outlined below.

Areas for improvement

Consultations to date with the industry have revealed two key areas for examination:

- the treatment of capital equipment that is used for both research and production purposes; and
- the allocation of certain overhead and administration costs between SR&ED and other activities.

The current rules provide tax credits for capital equipment that is used "all or substantially all" – that is, 90 per cent or more – in SR&ED activity. No credit is earned in respect of equipment that is used more than 10 per cent in production activities. Concerns have been expressed by firms which conduct their research or product development within their production facility – "shop-floor" research. In some cases, these firms are unable to receive tax credits for equipment that is used jointly for SR&ED activities and manufacturing. Although it may be more efficient to solve the problems of product development in a shop-floor setting, firms may duplicate certain facilities in order that the research component will qualify for the SR&ED tax credits.

There are also circumstances where equipment is used initially for research and development but is subsequently used in other activities. An example of this type of transformation is a pilot plant that, if successful, might then be used for manufacturing new products. This circumstance gives rise to questions as to both the level and timing of SR&ED incentives that should be allowed.

Another area of concern is the allocation of overhead and administration expenses. In determining whether an expenditure is eligible for a tax credit, the taxpayer must demonstrate that the expenditure is incremental – that is, the expenditure would not have been incurred if the SR&ED activity had not taken place. Documenting this incrementality for overhead and administration expenses can impose a significant compliance burden on taxpayers, particularly for smaller firms which may lack detailed accounting systems. It also creates a potential bias in favour of sole-purpose SR&ED facilities.

The government will finalize specific proposals to address these concerns in discussions with industry. It is expected that changes will be announced in the summer.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
(millions of dollars)					
0	-50	-55	-60	-65	-230

TARGETING CAPITAL GAINS EXEMPTION TO PRODUCTIVE INVESTMENT

The tax system contains a number of incentives to encourage investment. These incentives must be adjusted periodically to ensure that they reflect the fiscal capacity of the government and that they respond to changing economic conditions. With this in mind, the budget proposes to target the lifetime capital gains exemption (LCGE) toward equity investment by no longer providing the $100,000 lifetime capital gains exemption on real estate purchased after February 1992 and restricting it on real estate purchased before March 1992.

This initiative responds to the economy's growing demand for investment funds. In combination with initiatives in this budget to improve the competitiveness of the manufacturing sector and to make the R&D incentives more effective, this measure will help direct resources towards productive investments which enhance Canada's ability to compete in international markets.

The change does not apply to real estate that is used in an active business. For example, if a hardware store owner sold a building which was used principally in the business, it would be eligible for the lifetime capital gains exemption on the entire capital gain realized. This change also does not affect the $500,000 exemption for qualified small business shares and qualified farm property, nor the exemption on principal residences.

To provide an orderly transition for existing real estate, capital gains that have accrued up to budget day will continue to be eligible for the exemption. The eligible amount will be

determined when an individual realizes gains on such property by using a simple formula which prorates the total gain realized on the basis of the holding period prior to and after budget day.

For example:

John bought a duplex on March 1, 1988 for $90,000. One year later, he made $10,000 worth of improvements on his property. He sold the duplex in February 1994 for $180,000.

His total capital gain is $80,000 ($180,000 selling price less $100,000 cost)

He owned the duplex for 48 months before March 1992.

He owned the duplex for a total of 72 months.

He applies the following formula to determine the amount of capital gains eligible for the lifetime capital gains exemption.

	Capital gains	$80,000
X	[Number of months held before March 1992] / Total number of months held	48 / 72
=	Gains eligible for LCGE	$53,333

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
		(millions of dollars)			
10	80	210	315	365	980

LABOUR-SPONSORED VENTURE CAPITAL FUNDS

The budget proposes three modifications to the labour-sponsored venture capital regime. These changes include increasing the maximum credit for investments in labour-sponsored funds, relaxing the eligibility criteria for national funds and increasing the limit on the size of firms in which a fund may invest. These modifications support Canadian competitiveness by encouraging larger pools of venture capital.

What is a labour-sponsored venture capital corporation?

Labour-sponsored venture capital corporations (LSVCCs) are investment funds set up by labour organizations in which individuals pool their money to purchase shares in small businesses. The federal and some provincial governments have LSVCC programs which provide tax credits to LSVCC contributors.

To be eligible for tax credits, the funds must abide by certain rules – for example, restricting their investments to small businesses and requiring contributors to leave their money in the fund for a certain period. These rules are aimed at making sure that small businesses receive the intended benefit.

Tax credits are worth 20 per cent of the amount contributed, up to a ceiling. In certain cases, both federal and provincial tax credits are available, providing contributors with total credits of up to 40 per cent.

The federal government provides a tax credit for national labour-sponsored venture capital funds and matches credits for qualified provincial funds. The existing credit for investments in national labour-sponsored venture capital funds is equal to 20 per cent of the cost of the shares acquired on the first $3,500 investment (maximum credit of $700 per annum). This limit will be increased to $5,000 so that individuals may receive up to a $1,000 tax credit. In the case of provincial funds, the federal government matches credits provided by the province up to a maximum of $700. This maximum will also increase to $1,000 per annum. These enhanced limits will increase the level of venture capital available in the economy and thus help to support developing corporations which may have difficulty acquiring more traditional sources of financing.

Under the existing rules, national labour-sponsored venture capital funds must be established by a national labour body composed of at least two trade unions each of which represents employees in more than one province. The budget proposes to relax this restriction and allow venture capital funds to be sponsored by a single union provided that it represents employees in at least two provinces. This change encourages larger pools of venture capital through the establishment of additional labour-sponsored funds while maintaining the national focus of the federal credit.

A number of restrictions currently apply to labour-sponsored venture capital funds in order to ensure that the investments are targeted to small and medium sized enterprises. One of these restrictions is that the fund must concentrate its investments in firms whose total assets do not exceed $35 million. The budget proposes to increase this limit to $50 million. This increased limit applies not only to labour-sponsored venture capital funds but also to retirement income plans investing in small Canadian business either directly or through small business investment corporations, small business investment limited partnerships and small business investment trusts. By making such investments, retirement income plans obtain the right to hold extra foreign assets in their portfolio.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
(millions of dollars)					
0	-5	-5	-5	-5	-20

SMALL BUSINESS FINANCING MEASURES

The small business sector plays an important role in creating economic activity and jobs. In recognition of this, the federal tax system contains a number of provisions specifically targeted at small businesses (see box). The measures provide Canadian small businesses with over $3 billion of support annually.

SMALL BUSINESS TAXATION

Canada's federal tax system offers significant support for small business.

Lower tax rates

Canadian small businesses enjoy a special deduction that reduces their federal income tax rate from 28.8 to 12.8 per cent (including the 3 per cent surtax) on the first $200,000 of business income.

Lifetime capital gains exemption

Canada's lifetime capital gains exemption provides an incentive for individuals to invest in small business. Dispositions of qualified small business shares are eligible for an exemption of $500,000. In addition, only 75 per cent of capital gains above the exemption are subject to income tax.

Research and development tax credits

Small businesses qualify for the most generous incentives for research and development in the G-7 countries, including a 35 per cent refundable federal tax credit (instead of the general rate of 20 per cent) that puts cash directly into the hands of small business.

Overall, Canada's federal tax system for small business is one of the most beneficial in the industrialized world. For example, compared to the United States, our tax rates are lower, our R&D incentives more generous and our taxes on dividends and capital gains earned on investments in small businesses are lower. This supplements other advantages provided by government, such as publicly funded health care.

In the current economic environment, many small businesses are experiencing severe cash-flow problems. Despite efforts to rationalize their operations and reduce costs, declining revenues have threatened the ability of many small businesses to cover financing expenses.

In order to provide greater assistance to small businesses and to help stimulate the process of recovery in the economy, the government proposes two measures for small businesses:

- the introduction of a "Small Business Financing" (SBF) program as a temporary measure for small businesses in financial difficulty; and
- the broadening of the scope of the *Small Business Loans Act* (SBLA) by increasing the maximum individual loan amount from $100,000 to $200,000.

Small business financing program

The program will be available to both incorporated and unincorporated businesses. To ensure that it is up and running quickly, the detailed rules for the program will be identical to those for Small Business Development Bonds and Small Business Bonds as they applied in 1987 before those programs terminated.

The SBF program will permit qualifying small businesses to borrow money at interest rates below those normally charged in the commercial market, by treating the interest payments to the lender as dividends – qualifying, in the case of a corporate lender, for the intercorporate dividend deduction and, in the case of an individual lender, for the dividend tax credit. This program will enable lenders to charge businesses lower interest rates while maintaining the same after-tax rates of return.

The SBF program will permit eligible small business corporations and unincorporated businesses to issue small business financing instruments after budget day and before January 1993.

Small business financing instruments must be issued for a term of not less than one year and not more than five years and must have a principal amount of at least $10,000 but not more than $500,000.

The following table illustrates the advantages of the Small Business Financing program on a $100,000 financing.

Table 4.9

Illustrative effects of the SBF program

	Without program	With program
Principal	$100,000	$100,000
Assumed interest rate	10%	10%
Financing cost reduction due to SBF[1]	0	-4%
Effective financing rate	10%	6%
Financing cost to borrower	$ 10,000	$ 6,000
Savings to borrower		$ 4,000

[1] The exact amount of the interest rate reduction will depend on the circumstances faced by each lender.

Access to the Small Business Financing Program will be restricted to corporations, individuals and partnerships that may reasonably be viewed as being unable to obtain ordinary debt financing. In particular, access to the SBF program will be limited to those small businesses that:

- by reason of financial difficulty, are in default, or may be expected to default, on a debt held by a person dealing at arm's length;
- issue the obligation as part of a court-approved proposal or arrangement with creditors pursuant to the *Bankruptcy Act*; or
- issue the obligation at a time when all or substantially all (90 per cent or more) of the borrower's assets are under the control of a receiver, receiver-manager, sequestrator or trustee in bankruptcy.

Small Business Loans Act

The *Small Business Loans Act* (SBLA), first passed in 1961, assists small business to access financing for investment purposes by providing guarantees on loans from conventional lenders to finance land, premises and fixed and movable equipment. Since 1961, more than 280,000 loans, totalling more than $7.6 billion, have been authorized under the Act.

Since 1980, the maximum amount of loans outstanding to any individual firm under the Act has been $100,000. In response to representations from the small business community, and recognizing changes which have occurred over the past decade, the government will be taking action to amend the legislation as quickly as possible to double this ceiling to $200,000.

The current legislation authorizing the SBLA program expires March 31, 1993. As part of new legislation which the government will introduce in the Fall of 1992 to extend the program, review and consideration are being given to modifying other program terms and conditions to take account of concerns and needs expressed by smaller firms and the banking community.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
(millions of dollars)					
-20	-20	-10	-10	-10	-70

WHAT MORE CAN BE DONE

With these changes, the government has taken steps to ensure that the Canadian tax system remains competitive. Over the coming months, there are a number of areas where further work will proceed.

The government will finalize its consultations with the R&D community on specific proposals to improve the administration of the system of SR&ED tax incentives.

The government will be continuing its consultations as part of the Prosperity initiative. These discussions will focus on a broad set of issues, such as the macroeconomic environment, the regulatory framework and our educational and training system.

Finally, provinces have an important role to play in enhancing competitiveness. Provincial structural policies, taxes, regulations and the overall economic environment which they create are important influences on investment decisions and job creation. In today's economic environment, it is especially important that different levels of government co-ordinate their economic and fiscal policies to enhance Canada's competitive position. The federal government is proposing action on a number of fronts to improve Canada's competitive position. These changes will promote productive economic activity in Canada over the long term and will stimulate investment in the near term to accelerate the recovery process.

It would be desirable for provincial governments to examine how they might build on and reinforce these actions.

Provinces should also seriously examine harmonizing their sales tax systems with the GST. This would not only significantly reduce compliance costs but also would improve the competitiveness of Canadian businesses. By removing provincial sales taxes on business inputs, harmonization would reduce the cost of capital in Canada by about 3 per cent – adding to the 4 per cent reduction resulting from replacing the old federal sales tax with the GST.

D. Other tax Measures: Life insurance companies

Background

Life insurance companies have been subject to corporate income tax since 1969. Many of the rules used to determine income from carrying on an insurance business for Canadian income tax purposes are complex and unique to this industry. These rules generally relate to the computation of reserves of life insurance companies and the gross investment revenue of resident multinational life insurance companies and non-resident life insurance companies. These specialized rules were designed to recognize the unique nature of the industry and to include in the tax base only Canadian source insurance business income. All other Canadian multinational companies operating outside of Canada through branches are taxed on the basis of their worldwide income.

Taxation of the life insurance industry in Canada

Since 1969, life insurance companies have been liable for tax on profits not distributed to their policyholders.

In 1969, other countries taxed life insurance companies in various ways – some imposing premium taxes, others imposing taxes just on net investment income, while others taxed underwriting gains at a preferential rate. For this reason, the government at the time decided to exempt income associated with foreign branch operations from Canadian income tax.

This treatment was (and remains) unique to the life insurance industry. All other Canadian multinational companies operating outside of Canada through branches were (and are) taxed on the basis of their worldwide income.

The tax systems of other countries where Canadian life insurance companies do business have changed considerably since 1969. The trend in many countries is to tax the profits generated by life insurance companies in a manner similar to other financial institutions. This includes the United States where Canadian life insurance companies conduct 80 per cent of their foreign business.

In order to increase the effectiveness of the tax rules, many important changes have been made to these rules since 1969. Further changes were made as part of Tax Reform in 1987. A basic objective of Tax Reform was to levy a fair level of income tax across competing financial institutions. Changes were introduced with respect to insurance companies which restricted the amount of deductible reserves and improved the measure of gross investment revenue for tax purposes.

These changes attempted to correct serious deficiencies and were made after extensive consultations with the life insurance industry. At that time, the government announced that further changes would be examined in the area of the deductibility of policy reserves following the review of reserve calculations being undertaken by the Office of the Superintendent of Financial Institutions in consultation with the accounting and actuarial professions.

Despite these measures, income tax revenues from this industry remain low. Indeed, most large resident multinational life insurance companies have paid little or no income tax since 1969. Income tax revenues are low despite the fact that the industry reported annual net profits (before income tax) of $1.0 - 1.3 billion per year on their Canadian operations over the period 1987-1990.

As a further step toward ensuring that the life insurance industry pays its fair share of tax, the 1990 budget announced that the capital tax on financial institutions, the Part VI tax, would be extended to large life insurance companies. This change has resulted in increased revenues from life insurance companies. However, further action is required if the income tax system is to generate an amount of tax that is commensurate with the level of profits reported annually by this industry.

Part VI tax

The Part VI tax on capital of financial institutions applies to banks, trust companies and life insurance companies with financial capital in excess of $200 million.

The capital tax was initially imposed on banks and trust companies as part of Tax Reform because some financial institutions were not expected to pay income tax until their holdings of after-tax financing instruments matured. Since the capital tax is fully creditable against income tax, tax payments were effectively brought forward to the early years of Tax Reform.

The tax was extended to large life insurance companies in 1990.

Proposed action

The government is reviewing, with the industry, the taxation of life insurance companies to ensure that they pay their fair share of federal tax.

The life insurance industry agrees that the current income tax system is not generating an appropriate amount of income tax revenue. The business of life insurance companies has changed substantially since the income tax rules were designed in 1968 (see box). Life insurance companies are increasingly competing in markets with other financial institutions.

Evolution of the life insurance industry in Canada

Life insurance has been sold by companies operating in Canada since before Confederation. For many Canadians, their life insurance policies were a form of savings as well as insurance protection.

In 1969, about 65 per cent of the liabilities of insurance companies were associated with term insurance and traditional whole life-insurance policies.

Today, on the other hand, about 80 per cent of the liabilities of life insurance companies relate to annuities which, in many cases, are akin to Guaranteed Investment Certificates sold by other financial institutions.

Life insurance companies have captured about 20 per cent of the Canadian RRSP market. Life insurance companies have also broadened the scope of financial services they offer their clients through the acquisition of trust companies. The competition between financial institutions is increasing rapidly.

The government is engaged in ongoing discussions with the industry to find solutions. These discussions have been helpful in highlighting the key problems with the current system. Over the next few months, the government will outline specific proposals to ensure that life insurance companies pay an appropriate amount of tax over the short term and the long term. On the basis of these proposals, it is expected that life insurance

companies will pay an additional $55 million in federal tax in fiscal year 1992-93 and $75 million in fiscal year 1993-94.

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year total
(millions of dollars)					
55	75	85	95	105	415

TAX CHANGE AFFECTING ETHANOL AND METHANOL FUELS

Federal excise taxes on motive fuels are currently not applied to ethanol or methanol when these fuels are the main component of a motive fuel. Similarly, these levies are not applied to propane and compressed natural gas (CNG) used as motive fuels. However, the full excise tax on gasoline and aviation gasoline is applied to fuels that include low levels of ethanol or methanol but have gasoline as their main component.

The budget proposes to eliminate the excise tax on the ethanol and methanol portions of blended fuels that are mainly gasoline, effective April 1, 1992. This change will result in a tax reduction of 8.5 cents per litre of ethanol made from biomass and used in gasoline type fuels. The measure will cost approximately $25 million over five years.

The purpose of this measure is to encourage the development in Canada and use of ethanol and methanol fuels made from renewable feedstocks. Ethanol fuels derived from biomass offer a number of important environmental benefits. For example, these fuels generate lower levels of carbon monoxide than in the case of gasoline. They can also contribute to a reduction in carbon dioxide emissions, one of the "greenhouse gases".

Revenue Impact

1992-93	1993-94	1994-95	1995-96	1996-97	5-year Total
(millions of dollars)					
-1.8	-2.6	-3.5	-7.7	-8.8	-24.4

NOTICE OF WAYS AND MEANS MOTION TO AMEND THE INCOME TAX ACT

That it is expedient to amend the Income Tax Act and to provide among other things:

Small Business Financing Program

(1) That sections 15.1 and 15.2 of the Act relating to small business development bonds and small business bonds be made applicable to debt obligations issued in circumstances of financial difficulty after February 25, 1992 and before 1993.

Disability-Related Modifications to Buildings

(2) That the provisions respecting the current deduction for costs of eligible disability-related modifications to a taxpayer's building be extended to include costs incurred after February 25, 1992 for the installation or acquisition of elevator car position indicators, visual fire alarm indicators, telephone devices, listening devices for group meetings and disability-specific computer software and hardware attachments to assist individuals having a sight or hearing impairment.

Child Care Expenses

(3) That, for the 1993 and subsequent taxation years, the maximum amount deductible for child care expenses in respect of each eligible child of a taxpayer be increased by $1,000.

Capital Gains Exemption

(4) That the $100,000 lifetime capital gains exemption be restricted in respect of the taxable capital gain of an individual, realized on the disposition after February, 1992 of non-qualifying property, to that portion of the taxable capital gain realized on the disposition that

(a) the number of months after 1971 and before March, 1992 in which the property was owned since it was last acquired by the individual

is of

(b) the number of months after 1971 in which the property was owned since it was last acquired by the individual

and, for the purpose of this paragraph and paragraph 6, non-qualifying property of a person means

(c) real property, other than qualified farm property or property that at all times while it was owned by the person or the person's spouse during the 24 months preceding the disposition of the property was used principally in an active business carried on by the person, the person's spouse, child or parent or by a corporation, partnership or trust in which shares or interests representing all or substantially all of the fair market value of such shares or interests are owned by persons referred to in this subparagraph,

(d) a share of the capital stock a corporation (other than a qualified small business corporation share or a share of a family farm corporation) the fair market value of which was derived principally from non-qualifying property,

(e) an interest in a partnership (other than a family farm partnership) or a trust, the fair market value of which was derived principally from non-qualifying property, and

(f) an interest or an option in respect of property referred to in subparagraph (c), (d) or (e).

(5) That, for the 1992 and subsequent taxation years, the cumulative net investment loss of an individual be reduced by net taxable capital gains in respect of which the capital gains exemption is not available.

(6) That the $100,000 lifetime capital gains exemption not be available in respect of capital gains dividends paid to an individual by an investment corporation, mortgage investment corporation or mutual fund corporation or capital gains designated in respect of an individual by a mutual fund trust, with respect to a capital gain realized by such corporation or trust on the disposition after February, 1992 of non-qualifying property except to the extent of the portion of the gain that the number of months before March, 1992 and after 1971 in which such property was owned after it was last acquired by such corporation or trust is of the number of months after 1971 in which such property was so owned by it.

Medical Expenses

(7) That, for the 1992 and subsequent taxation years, the list of eligible medical expenses for the purposes of the medical expense tax credit be expanded to include the cost of visual or vibratory signalling devices for those with a hearing impairment and expenses for rehabilitative therapy to adjust for speech or hearing loss, including training in lip reading and sign language.

Education Tax Credit

(8) That, for the 1992 and subsequent taxation years, the monthly amount on which the education tax credit is calculated be increased from $60 to $80 and extended to part-time students at a qualifying post-secondary educational institution who are eligible for the disability tax credit or who, by reason only of their mental or physical impairment as certified in prescribed form by a medical doctor, cannot be enroled on a full-time basis.

Transfer of the Tuition Fee and Education Tax Credits

(9) That, for the 1992 and subsequent taxation years, the maximum amount that may be transferred by a student to a spouse or supporting individual in respect of the student's tuition fee and education tax credits be increased from $600 to $680.

Child Tax Benefit

(10) That, for the 1993 and subsequent taxation years, the provisions of the Act relating to the taxation and the repayment of family allowances and the granting of the refundable child tax credit and the non-refundable credit in respect of children under 18 years of age be repealed and replaced with a single child tax benefit payable monthly to eligible individuals in accordance with the proposals described in the Budget Papers tabled by the Minister of Finance in the House of Commons on February 25, 1992.

Manufacturing and Processing Corporate Tax Rate

(11) That the basic rate of federal corporate tax, after the 10% provincial abatement, payable on Canadian manufacturing and processing profits (other than profits eligible for the small business deduction) be reduced to 22% commencing January 1, 1993 and to 21% commencing January 1, 1994, and that these changes in tax rates be pro-rated for taxation years that straddle these dates.

Labour-Sponsored Venture Capital Corporations

(12) That the provisions relating to labour-sponsored venture capital corporations be amended for the 1992 and subsequent taxation years to:

(a) increase the $700 maximum tax credit to $1,000 for investments in national and provincial labour-sponsored venture capital corporations,

(b) increase the asset limit of "eligible business entities" from $35 million to $50 million of total assets, and

(c) extend the definition of "national central labour body" to include a single trade union that represents employees in at least two provinces.

Earned Income

(13) That the amount of disability pension received after 1990 by an individual under the Canada or Quebec Pension Plan be included in the definition of "earned income" for purposes of determining the amount deductible for contributions to a registered retirement savings plan.

Home Buyers' Plan

(14) That individuals be entitled to withdraw funds after February 25, 1992 and before March 2, 1993 from their registered retirement savings plans to acquire a home in accordance with the rules set out in the draft amendments to the Act relating to the Home Buyers' Plan tabled by the Minister of Finance in the House of Commons on February 25, 1992.

RRIFs for Lifetime

(15) That, for the 1992 and subsequent taxation years, the provisions relating to registered retirement income funds be amended to allow payments to continue throughout the lifetime of the annuitant and the minimum amounts required to be withdrawn under such funds be adjusted accordingly.

Pension Contribution Limits

(16) That, for the purposes of applying the rules relating to registered pension plans, deferred profit sharing plans and registered retirement savings plans, the money purchase limit be changed to:

(a) $12,500 for 1992,

(b) $13,500 for 1993,

(c) $14,500 for 1994,

(d) $15,500 for 1995, and

(e) for each year thereafter, $15,500 indexed by the growth in the average industrial wage in Canada.

Interest on Tax Refunds

(17) That no interest be payable to an individual on any overpayment of tax related to a tax return filed after 1992 for the period ending 45 days after the later of the due date of the return and the day on which the return was filed.

Individual Surtax

(18) That the individual surtax under paragraph 180.1(1)(a) of the Act be reduced from 5% to 4½% for the 1992 taxation year and to 3% for subsequent taxation years.

Common-Law Spouse

(19) That, in the application of the provisions of the Act after 1992, two individuals of the opposite sex be considered to be spouses of each other when they are cohabiting in a conjugal relationship and either

(a) they have so cohabited throughout the preceding 12 months, or

(b) they are the parents of the same child.

NOTICE OF WAYS AND MEANS MOTION TO AMEND THE EXCISE TAX ACT

That it is expedient to amend the Excise Tax Act to provide among other things:

1. That where gasoline or aviation gasoline has been blended with alcohol to produce a gasoline-alcohol or aviation gasoline-alcohol fuel containing not less than 1.35% alcohol by volume, the excise tax imposed on gasoline or aviation gasoline, as the case may be, not apply to that portion of the gasoline-alcohol or aviation gasoline-alcohol fuel equal to the percentage by volume of alcohol in the fuel.

2. That for purposes of any enactment founded on paragraph 1 of this motion, "alcohol" be defined to include ethanol and methanol produced from biomass or renewable feedstocks but not to include ethanol or methanol produced from petroleum, natural gas or coal.

3. That any enactment founded on this motion be effective on and after April 1, 1992.